TAX POLICY: WHAT DO FAMILIES NEED?

HEARING

BEFORE THE

SELECT COMMITTEE ON CHILDREN, YOUTH, AND FAMILIES HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

HEARING HELD IN WASHINGTON, DC, ON
WEDNESDAY, APRIL 24, 1985

Printed for the use of the
Select Committee on Children, Youth, and Families

U.S. GOVERNMENT PRINTING OFFICE

47-748 O WASHINGTON : 1985

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, DC 20402

H961-25

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TAX POLICY: WHAT DO FAMILIES NEED?

WEDNESDAY, APRIL 24, 1985

HOUSE OF REPRESENTATIVES,
SELECT COMMITTEE ON CHILDREN, YOUTH, AND FAMILIES,
Washington, DC.

The committee met, pursuant to call, at 9:05 a.m., in room 2218, Rayburn House Office Building, Hon. Patricia Schroeder (acting chairwoman of the committee) presiding.

Members present: Representatives Lehman, Schroeder, Evans, and Coats.

Staff present: Anthony Jackson, professional staff; Anne Wynne, professional staff; and Joan Godley, committee clerk.

Mrs. SCHROEDER. If we may, I think we will go ahead and convene the hearing because of the craziness of the day. Congressman Coats and I had set this at a time when we did not anticipate both parties having major caucuses this morning.

I want to thank everybody for coming. We are really hoping that, when we come away from this hearing, we will have a better focus on what Federal tax policies should be for families, focusing on two things: how the present Tax Code affects families and hoping that we get a commitment to make sure that any future tax policy or tax program that the Congress passes will have a much fairer approach to families and how they are taxed.

If you look at our present Tax Code, there appears to be very little in it for families. The loop holes, shelters, depletion allowance, accelerated cost recovery systems, all seem to be geared to things other than families. You have heard many times people saying that you can deduct all the costs associated with taking care of animals if you are raising greyhounds or race horses. However, with children you get a $1,000 a year exemption, and if there is anyone who knows how to raise a child for that, it would be very interesting to see their book. It should be an instant best seller.

If you take the exemption, which is the primary means that the Tax Code uses to adjust for family size, it would be worth over $2,600 if it had been indexed for inflation beginning with 1948. I think we have to change our thinking from viewing children as a consumption item to recognizing them as an investment item. And, as investment items, they should be accorded much more favorable treatment in the Tax Code.

We must take special steps to ensure that poor working families are not taxed as they currently are. I find it outrageous that poverty-level families pay income taxes. In fact, in 1978 a family of four at the poverty level paid $269. However, in 1984 the similar low-income family paid $711 in payroll taxes and $365 in income taxes,

raising that burden from $269 to now $1,076. This is an increase of over 300 percent.

Tax provisions designed to assist low-income working families such as the earned income tax credit must be strengthened and expanded so they can achieve their purpose. No family working to make ends meet should be further driven into poverty by an unfair tax burden.

[Opening statement of Hon. Patricia Schroeder follows:]

OPENING STATEMENT OF HON. PATRICIA SCHROEDER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

I'm delighted to be here today. I hope that we come away from this hearing, which will focus on what Federal tax policy should be for families, with two things: A better understanding of how the present Tax Code affects families by familiarizing ourselves with the basic provisions that most affect families, and a commitment to work for a fair family tax policy as the Congress moves forward with its consideration of the various tax simplification plans now before it.

It is clear that our present Tax Code increasingly has nothing in it for families. The tax acts that have been passed over the last two terms of Congress contain no loopholes, shelters, depletion allowances, or accelerated cost recovery systems for taxpayers raising families. Taxpayers raising greyhounds, though, get to deduct all the costs associated with taking care of such animals. It seems to me that we as a nation have our priorities skewed. It costs money to raise children, far more than the $1,000 exemption that was allowed in 1984. This exemption, which is the primary means by which the Tax Code adjusts for family size, would be worth over $2,600 if it had been indexed for inflation since 1948. We have to change our thinking from viewing children as a consumption item to recognizing they are an investment item, and as such should be accorded more favorable treatment in the Tax Code.

We must take special steps to ensure that poor working families are not taxed as they currently are. It is absolutely outrageous that poverty level families pay income taxes. In 1978 a family of four at the poverty level had a total Federal tax burden of $269. In 1984, a similar low income family paid $711 in payroll taxes and $365 in income taxes for a total federal tax burden of $1,076. This is an increase of 300 percent. Tax provisions designed to assist low income working families such as the earned income tax credit, must be strengthened and expanded so that they will achieve their purpose. No family working to make ends meet should be driven further into poverty by an unfair tax burden.

Our first witness will be the Senator from New York, Patrick Moynihan. Senator Moynihan has long been an advocate of familes, and is here today to offer his thoughts about ways in which we can structure a tax policy that helps families.

I am now going to yield to the gentleman from Indiana, Mr. Coats, my ranking member, who has a statement.

Mr. COATS. I thank the chair. I thank you particularly for convening this hearing. We didn't realize until late last evening that it would be convened under some very difficult circumstances.

This is a subject near and dear to my heart. I have invested a great deal of personal time and a great deal of our staff time on the subject of tax fairness for families, which I think would be an appropriate title for this particular hearing.

We have looked at the statistics, and you have mentioned some. Others will be presented to us today that show an inherent unfairness that exists in our current Tax Code. I am not sure it is deliberate. I don't subscribe to a conspiracy theory to do away with families in this country. But the effects are the same. The effects are that families are penalized under our Tax Code, and that has had a direct relationship to incidences of poverty, difficulties with the family and dependence on many Federal welfare programs.

The statistics are truly alarming in terms of the penalty against the family. Single taxpayers and taxpayers and spouses without children have seen their tax rate remain relatively level since 1960 due to a number of advantages and breaks given to them in the Tax Code. Yet, a family with two children has seen its average tax rate rise 43 percent. A family with four children has seen their average tax rate rise more than 200 percent during that time period.

I have had the opportunity to discuss these problems on several nationally broadcast talk shows. The response from listeners has been overwhelming. I just brought some of the hundreds and hundreds of letters we have received from 45 of our 50 States which show the reaction of families. If I could, I would like to just quote from a couple of those letters.

I have the letters, but I also have them summarized here, which might be easier.

A woman from Hamburg, NY, says:

My husband needs the dignity of being able to bring home most of his pay and not stand in line for government surplus and other handouts. The tax exemption for his children should be more than doubled. He should not have to pay the Federal deficit by himself.

A writer from Jacksonville, FL, said:

Thank you for your interest in helping take some of the burden off the backs of the taxpayers that are not able to walk the halls and lobby in the Capitol Building.

A letter from Bay Village, OH:

I never collected unemployment compensation in my life. When one job wasn't enough, I had to moonlight and still care for the house and children. You see, I have no writeoffs, tax shelters, or loopholes.

Someone from Buckeye, AZ, wrote:

I feel the time has come that we need our families to be considered. After all, the Constitution says "We the people", not "We the lobbyists."

And this could go on. I could go on and on with hundreds and hundreds of quotes. I would like consent from the chair to insert some of these in the record.

Mrs. SCHROEDER. Without objection.

[The information follows:]

AMERICAN FAMILIES WANT TAX FAIRNESS

Since introducing a bill to double the personal exemption about a month ago, I have received over eight hundred letters from families in almost all 50 states. The tone of these letters is not that of people asking for any favors. Most people don't expect to be on the receiving end of tax policy. They know that taxes are something taken from them, not given to them. But over the past couple decades, the federal government has been taking a greater and greater share of families' incomes in taxes, while taxes for single persons and couples without children has remained about the same. We have been taxing families from the resources they need to raise their children, and now families are crying out for simple fairness.

Those who have written to me in the last month describe their situation and their outrage much more eloquently than I am able to do. I have extracted parts of their letters which I wish to make part of the hearing record. These are the voices of America's families.

DAN COATS,
Ranking Minority Member.

Tucson, Arizona: I feel the family unit has been discriminated against long enough and am glad someone is finally standing up for them.

Southard, Oklahoma: We have two children and we're a bit surprised to hear that the tax exemption used to be 24 percent of income and now is a mere 8 percent of our income. So let us support our families and not give all the big tax breaks to "Big business".

Elba, New York: We feel that tax exemptions are not fair and should be at least doubled. We need more money to raise our families on. Even the people on welfare get that, and my husband and I both work.

Omak, Washington: I'm writing about Tax Fairness for Families. We all really need some tax help.

Big Sky, Montana: Please lobby for Tax Fairness for Families. Raised deductions would help to lift the burden on low income families.

Sunrise, Florida: We are a family of five and if there is anything you can do to save us some money to buy food which would otherwise be taxed money we would appreciate it.

Topsham, Maine: I was so very pleased to see you with a bill for tax fairness for families that seeks to try to keep pace with inflation and that—as families do not lobby for keeping pace with inflation, as other special interests do, this bill will try to make up for inflation. Please see that this letter (copies of) are given to my Maine representatives.

Pittsburg, California: I'm glad someone is finally doing something to benefit us with families. I also wrote my Congressman . . . I hope he will support your bill.

Ewa Beach, Hawaii: As a working mother of three who would much prefer to raise her children, I am very much in support of H.R. 1551 the "double exemption" bill. I am convinced that the current tax structure discriminates against the American family and "forces" many of us women out into the workforce just to make ends meet. I am prepared to solicit additional grass roots support for this or any other bill that could provide relief for women like myself who sincerely desire the choice once available of being just a homemaker.

Portsmouth, New Hampshire: Please continue to work for the $2,000 plus deduction for families in the United States. Thanks also for your interest in ridding the country of high cost & pressuring lobbyists and special corporation interests.

Dickinson, Texas: I am very happy to see you speak up for families. It could be to your political advantage to be a champion of some group with more visible political clout, so it speaks very well of you. I very much support doubling the personal exemption as you suggest in H.R. 1551. It may not seem like much money but it can mean a lot to a family. It's a shame that legislators got so busy spending our money that now that they find they've been unfair to one group (families) they are not even in the position to make it right.

Clinton, Connecticut: Please encourage this tax reform for families. We are all hanging on by a string. Our young people need to be hopeful in the future, being able to have and support a family.

Sun Valley, California: We can not allow the government to tax the American family into extinction.

Newark, Delaware: I would like you to know that we feel that your bill for tax fairness to families is very important. We support your bill totally. Please let our senators know . . . It's about time somebody tried to change our mixed up tax system.

Morristown, Indiana: We are a family of four and my husband is our sole support. In today's economy we are lucky to be able to own our own home (actually the bank owns it). We cannot afford any extras. No vacations—no savings accounts—no air conditioning—no college fund. Our budget is stretched to the limit and we feel we're taxed to the limit. How unfair is it that we pay 20 percent in taxes and the many corporations pay only 6 percent or nothing at all. How about some tax reform to benefit the average family and not the profit margin of the corporation?

Tulsa, Oklahoma: My husband and I plan on having children in the future, what hope do we have when so many circumstances seem to be against the family today.

Tampa, Florida: My husband and I support your efforts for tax fairness for families. Please let other members of congress know of our stand.

Riverdale, New Jersey: Please double our deductions for children and give us more exemptions instead of taking them away—we can barely make it now.

Carson City, Nevada: We support the bill H.R. 1551 to double the exemption for families on their income tax.

Erie, Pennsylvania: I support this bill to double the exemption for families. I have raised five children as a widow, and I think its time for fairness!

Dallas, Texas: It seems to me that big business and the rich can figure out all kinds of loop holes to not pay taxes and to get all kinds of exemptions. But the people that are in need of help seem to have very few ways to escape the tax man

. . . I feel that the family is the most important unit that has made our country the greatest in the world . . . but it appears that some of the rich and I mean this literally, Government people could care less about the less fortunate . . . I feel like you that the family exemptions should be at least doubled or even quadrupled. . . .

Missoula, Montana: I believe this bill is overdue but at least its a start in the right direction. Please pass on my desires to the Montana elected officials.

Salisbury, North Carolina: I am strongly in favor of doubling exemptions . . . when a family earns every dollar honestly and does not cheat one iota on their taxes, why can't we have a break?!?

Oakley, California: It's time for tax fairness for families. We've been ignored long enough.

Moline, Illinois: My husband and I were both reared in large families. We had no idea the tax laws were so discriminatory towards large families. Our country was founded on freedom of choice and those of us who have large families shouldn't have to bear a heavier tax burden than those with small families or no children. We are only asking for equality.

Tuckerton, New Jersey: We support fairness legislation. Please push for its passage.

Springfield, Virginia: For too long I have perceived that our elected leaders have taken the average, hard-working, non-complaining family members for granted and little, if any, attention has been paid to our concerns or well being. I am extremely grateful that someone of your integrity and stature is willing to dedicate your time and energy in support of a matter that would be of benefit to one of the most stabilizing elements of our society, the American family.

Geddes, South Dakota: I want Dan Coats bill "time for fairness for families" passed.

West Palm Beach, Florida: . . . As a matter of fact, if the tax exemption would be increased to $3000 or $4000, I believe we would see many new job openings when mothers could then afford to stay home and raise and nurture their children—I believe many mothers would then feel free to leave the job market until their children were grown.

Bargersville, Indiana: We are so busy working to pay our taxes and get our children educated, without someone to help us who cares, the education and suburban way of live of middle class Americans looks doomed.

Coos Bay, Oregon: I have no children of deductible age, my youngest being in his mid-20s. I do recall how difficult it was from 1950s, as our family grew. We never seemed to have any more than barely enough from one month to the next. Because the situation has greatly worsened since those days, my heart bleeds for the young families of today. There are so many ways things could be improved for families, to make life better for them.

Pasadena, Texas: We agree that it is time for some fair legislation for the families of this country. I wish all families had seen you on TV last night and heard what you had to say. Thank you for your concern.

McHenry, Illinois: Everything has gone up with inflation except for the exemption we can declare for ourselves and our children. Why did it take so long for this to be questioned? But, now I am questioning this.

Honolulu, Hawaii: This increase is long, long overdue and we support you in your campaign to get this change made.

Brooklyn Center, Minnesota: We've got three kids and aren't having much success making it financially. They pay foster families more in 3 months for 1 child than they allow us to deduct on our taxes in 1 year for 3 kids! I'm not saying I want the government to give us any money. Just allow us to keep more of what little we do have so we at least have a fighting chance. Between income tax, property tax, sales tax, etc . . . even with both of us working, its near impossible to pay the bills and still have money left over for food and clothes. Please help us—tell us what we can do politically to help ourselves.

Hyndman, Pennsylvania: It's high time the government started to help us "normal" folk who are struggling to raise our children.

Decatur, Georgia: Thank you for standing tall for the traditional family.

Chandler, Arizona: We have 3 little children and are 25 years old, we need help. Thanks so much.

Bellingham, Washington: I have been somewhat discouraged in writing to my representatives because the letters I get in return clearly indicate they are not persuaded to any change in thinking.

Yonkers, New York: Thanks for speaking for those who are too busy providing basic needs as food, clothing and shelter to lobby in Washington.

Kenner, Louisiana: We heard about your efforts at Tax Fairness for Families. We are an older couple who have adopted an "unwanted" child. It is costing us so much money partly because she is "learning disabled." Also the adoption process is not for the working people, it should be only for the rich, because the costs are exorbitant, it is as though we were being punished by the system for bringing a needy child into our home. Your proposal toward family fairness in the taxation system seems a very good place to start toward some equity for the family. Quit giving all the breaks to General Dynamics, et al.

Lincoln, Nebraska: It is time for change in favor of the family.

Jenks, Oklahoma: If we do away with children and families, America has nothing.

Anchorage, Alaska: Please send pertinent information regarding your current campaign for Tax Fairness for Families and how we, as members of families and the general public, can get involved. I appreciate your interest and consideration for these matters.

East Meadows, New York: I have 7 grandchildren of a runaway mother . . . they were constantly living in fear she would return and kidnap them. They had failure after failure in school. Finally I stepped in. I wrote each child's teachers letters explaining the traumas they were all going through and if I could have extra assignments over the weekends to help them catch up to grades. Now after 5 years they are all up to grades 40–90 percent . . . The only thing I want you to answer is my grandson's question—"Grandmom, if things are so hard for you now, what's it going to be like when I grow up?" . . . another reply was "Grandmom I need you. Grandmom I need you, to help me grow up. Are you listening Grandmom, I know you're sick but you can't die, I need you to help me grow up. . . . So when you are deciding on helping the Corporations give a little thought to us and our needs. We love America and our families gave their lives for her. What did the Corporations do? Find loopholes and tax exemptions . . . I know Congressmen have families but they are all protected, they are not in want, so they do not honestly have the feelings for us. You see they're not needy. They never walked in our shoes. I don't mean to be rude but I feel after all these almost 65 years of living, I have a right to speak out the truth. America is there for everyone else but overlooks her own children.

Madison, Georgia: I was impressed with the Coats Bill to double the tax deduction for families. We're a family of four and we're tax poor! Please urge my congressman to support this bill.

Hector, Minnesota: I wanted to express to you my support for tax reform. Particularly the issue concerning the doubling of exemptions. You have my family's welfare in your hands. Please use your power and influence wisely and justly.

Gadsen, Alabama: We are concerned about fairness for families in tax reform. I am a small poultry farmer in Alabama. We love our country and want her to remain strong.

Amarillo, Texas: It's time for tax fairness for families.

Lakeside, California: We are a family of 4 and would like to voice our support of tax fairness for families. Please see that the right eyes see this note or the right ears hear our voice.

Setauket, New York: As grandparents we see the tremendous struggle families have today.

Kankakee, Illinois: Give us a break in tax—the burden is too heavy.

Beaverton, Oregon: I am pleased to know that legislators are recognizing the burden carried by families. Please make my Oregon legislators aware of my support for your efforts.

Port Neches, Texas: I want you to do all you can for making income taxes more fair for families. We don't have lobbyists like corporations do but please remember that the families of ordinary people need help to pay only their fair share of taxes.

Manassas, Virginia: The exemption needs to be improved to help the middle-class families, who are constantly giving, but receiving little in return. The family is the backbone of this country and should be supported, not ignored.

Spencer, Indiana: I do support your tax bill concerning the family. We have had 6 children; my husband has worked very hard as a truck driver trying to support the family yet I needed to work too to help and they were taking out more in taxes than I could earn. A mother and housewife.

Long Prairie, Minnesota: We have three children. I am a housewife with no income. It is not easy making ends meet on one paycheck. We could use a tax break.

Danville, California: Thank you for informing us this morning as to your working for more fairness to families with your tax reform package. Please continue in your good work.

Sunbury, North Carolina: It seems that if you try to work to make an honest living, and not go on welfare and be a deadbeat on the Government . . . it puts you

in another bracket, and more than before is taken away from you. My husband and I have no tax shelters to hide behind, like the real money people have, we are right out in the open, very vulnerable, and easy prey . . . So I hope something can be changed to give us a break.

Port Jervis, New York: I had no idea the tax structure favored singles and small families. Probably because we have 4 children and are very busy attempting to raise them with a sense of family strength and support. To me, the basic strength of this country is the family. Without family there is no sense of identity or community, there is no development of patriotism and concern for national affairs.

Lansing, Illinois: I want to speak for a large family—I have 3 sisters, 2 brothers, 65 nephews, 55 nieces, 3 married children, 9 grandchildren, 2 uncles, and lots and lots of cousins. We all talk about taxes for families. They live in Hammond, Crown Point, Cedar Lake, Monticello, Rockville and 2 live in Kentucky. Consider this for about 300 people.

Denton, Texas: Please do all that you can to provide tax breaks for families. Next year we have two daughters in college and two sons in junior high. We need support and encouragement and financial relief more than ever.

Gaithersburg, Maryland: I am in favor of doubling the individual tax exemption—this is long overdue—I can't believe it's taking so long to get tax reform done.

Hermosa Beach, California: Children are our most important resource, and care should be taken to not discourage families from bearing and raising children.

St. Francis, Wisconsin: The fairness in deductions is ridiculous right now. Please voice our opinion. Vote to give us more fairness in deductions.

Nogales, Arizona: I as well as lots of others in our agree!! The family—which I feel is the blood-bleeding way of most of taxes have no recourse in many ways to even survive!!!

Millbrook, New York: Please use this short note to express my concern for the need to bring about more fairness in the taxing of families. I support your efforts to bring about a higher rate for exemptions for each member of the family. My Congressional Representative is Congressman Hamilton Fish.

Palm Beach Gardens, Florida: We would like very much to see the family get a fair shake in the new tax reforms.

Bronx, New York: Our families are not getting the tax credits we deserve. My family and I appreciate your concern.

Medina, Ohio: I have been crying about this for many years to my own congressman and senators but to no avail.

Benson, Minnesota: We must work for the people who live on this blessed land. And not handouts, or even corporations getting out of everything. Our government must work to put dignity back in people, encourage them to work, and not sit back for a free handout.

Eureka, California: I just finished doing my income tax since today is "The Day." My husband and I both work. I work because I have to, not because it's my first choice.

Barlow, Ohio: The basic family unit is under much more stress than at any time in the history of this country. In my work, I see any number of families wilting, or indeed, breaking under the strain. To add to the stresses already present in modern life, the burden of unfair taxation, strikes me as being most unwise, to say the least.

Lakewood, Colorado: To realize the amount of the deduction per child has only changed from $600 to $1,000 between 1948 and 1985 is really unbelievable when you consider what has happened to the prices of clothes, food, housing, etc.

Oneonta, Alabama: Very unhappy about taxes. I think the tax system needs to be rebuilt around family needs. I am for the personal exemption going up to $2,000 or more. P.S. Why don't you consider running for President?

Garland, Texas: With medical costs and educational expenses being so high—pardon the personal example but I just added up our medical expenses for last week: $272 were spent on three children's doctor and drug bills (nothing unusual, no surgery, just viruses, immunizations and sinus infections, some of which are not covered by insurance). In addition I was told I need surgery and our teenage son must have braces not just for cosmetic reasons but because his jaw is so misshapen it's causing terrible headaches. Again, there is no insurance for this and the allowable medical deduction has been already altered. The standard deductible must be increased for dependents just to keep pace with these awful expenses that are common to all families.

Lawrence, Kansas: The American family is not a special-interest group. On the contrary, the family is the foundation of our Democracy and one of the chief responsibilities of the government is to preserve and encourage it. The problem is that, during the years since World War II, the needs of the family have gotten lost in the

rhetoric of special-interest groups, many of which would like to reduce or eliminate the role of the family. This situation must be changed, and since Congress is presently wrestling with the issue of tax reform, now is the time to act.

Hopewell, Virginia: I believe that most Americans do not mind paying our fair share of taxes, but what angers and disgusts me is—Congress listens to the lobbyists and not the people, which our government is to be for.

Mr. COATS. If I could I will now turn to a partisan subject which I hate to inject into what I believe truly in a nonpartisan hearing, and with apologies to Senator Moynihan.

We are experiencing, as most people know, a very difficult situation here in the House regarding the seating of one of our members from my State, Indiana. My friend and associate, Rick McIntyre, is not going to be seated in the House of Representatives even though under the laws of the State of Indiana he won the election on election night, even though under the laws of the State of Indiana he won the recount ordered at the request of his opponent and even though he was duly certified by our Secretary of State. But because this matter was placed into partisan politics and because the House Administration Committee on a party line vote saw fit not to seat Mr. McIntyre, a second recount was ordered under the direction of a House-appointed task force. And because that task force was constituted on a two-to-one majority/minority ratio, and because every disputed ballot was voted down on a two-to-one basis, Mr. McIntyre finds himself not being able to be seated.

The Republican conference has called an emergency session at 9 o'clock this morning. That is the reason that none of my colleagues are here, all of whom had indicated they would be here. It is because of that emergency session.

The Democrat caucus has called a similar emergency session.

Because Rick McIntyre is not only a friend and colleague, but someone I feel has been done a grave injustice, it is important that I be present at that other meeting. Even though this is a subject near and dear to my heart, and I regret deeply the fact that I have to leave and can't, Senator, stay for your testimony, I feel that it is important that I do this.

I do want to state that I have talked to my other colleagues on the Republican side. They regret, also that they can't be here. The Chair has graciously consented that the record can be left open for insertion of statements. I would ask unanimous consent now to officially confirm that the record be left open for 3 days, and that Congressman Kemp's testimony be inserted in the record at the point that he would have testified.

Mrs. SCHROEDER. Without object. In fact, we were planning to leave it open for 2 weeks.

Mr. COATS. That is even better. The Chair is even more gracious than I thought.

I deeply regret, Senator Moynihan, that I will not stay. I am taking your testimony with me, which I have already looked over.

I am intrigued by your remarks at Harvard and by some of what I think you are going to say this morning. I look forward to working with you on a bipartisan basis to bring about some tax credits for families in this much needed tax reform that is before us.

I apologize to the Chair, all the witnesses and all our staff who have put in so much time. I regret that I have to leave you this morning.

Mrs. SCHROEDER. Thank you very much.

Senator Moynihan, I am really honored to introduce you as our first witness. I am going to ask unanimous consent to put Chairman Miller's statement in the record at this point.

[Opening statement of Congressman George Miller follows:]

OPENING STATEMENT OF HON. GEORGE MILLER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA, CHAIRMAN, SELECT COMMITTEE ON CHILDREN, YOUTH, AND FAMILIES

Madam Chairwoman, I want to commend you for holding this hearing on the issue of tax policy and the family, and for assembling a very distinguished panel of witnesses.

During the Select Committee's National Initiative on Child Care last year, we heard repeatedly from parents and others about the problems current tax laws cause for families. One of the major recommendations in the Committee's report, "Families and Child Care: Improving the Options," endorsed by every committee member, called for a thorough review of tax policy and its effects on families.

Today we are fulfilling this promise. This hearing allows us a much needed opportunity to examine in greater depth how current tax law helps or hinders families in their efforts to provide for their children, and to identify new approaches which might be more equitable and beneficial to families.

We've learned, for example, that long-term increases in income and Social Security taxes, along with the dramatic decline in the value of the personal exemption, make the federal tax burden on this generation of American families far greater than that of previous generations. While taxes have gone up, median family income has actually declined over the last five years in real terms, and the cost of providing housing, food, education and health care for children continues to rise.

We know too, that taxes paid by low income families have increased tremendously in just the last few years. Since 1978, the combined federal income and payroll tax burden on a family of four with poverty level wages has increased 300%. Families with incomes well below the poverty line are now required to pay income taxes.

The bottom line is that for all but the wealthiest families, fewer resources are available to raise children. Add to this the chronically high levels of unemployment we now face, and the hundreds of billions in earnings lost in the last recession, and one begins to see the dimension of the pressures families and children face. The least we can do, under these circumstances, is review current policies and look for reasonable alternatives.

We will also have the opportunity today to consider alternatives which are more like the credits and allowances many other nations already provide to families to help them maintain an adequate standard of living for their children.

In the coming months, the Select Committee is looking forward to publishing a volume of papers on tax policy and the family, including papers presented at a conference, "Federal Tax Policy: What's In It For Women and Families?", sponsored by the Women's Research and Education Institute and the Family Impact Seminar.

This volume, the Fact Sheet prepared especially for this hearing, and these proceedings should at last place families and children at the center, not the periphery, of the tax debate in this country.

Mrs. SCHROEDER. We stood on the floor at 10 o'clock last night wondering what in the world to do as we heard both caucuses were convening and decided that, since they are also moving on tax policy at the same time, it is really important to fill the record and we can share it. So, thank you for coming in. The floor is yours. Thank you for all you have done for families.

STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator MOYNIHAN. Madam Chair, I shall be brief.

I thank you for having today's hearing and I thank the House for having created the Select Committee on Children, Youth and Families. Family policy is a subject whose time has come in our country. The response that Mr. Coats was describing to some of his comments on radio and television is one which is increasingly common. The situation of families must be addressed.

I have a statement which I will put in the record, if I might.

Mrs. SCHROEDER. Without objection.

Senator MOYNIHAN. I will sum up quickly my thoughts and respond to your questions, such as they may be.

We are developing a country in which, for the first time in history, you are far more likely to be poor if you are a child than if you are an older person. Since the last century or so, age has always been associated with poverty.

The poverty rate for the elderly—14.1 percent in 1983—drops to 3.3 percent, after taking into account in-kind income. This is a huge achievement and a good one, but not one that happend by chance. It was made to happen, and basically by the Social Security Act enacted 50 years ago. It took 50 years to happen, through Social Security. It is not just Social Security but a range of Federal support.

By contrast the rate of poverty among pre-school children when you adjust for in-kind income, it is 18 percent. About one child in four in America is poor. The chances of being poor as a child are six times greater than the chance of being poor as a retired person.

There is no group in this country that has as high a rate of poverty as children.

Second, if you think of a child's life chances, we can say with real confidence that 32 percent of the children born in 1980 will be on welfare before they are 18. A third of the children born in 1980 are going to be on the AFDC Program by the time they are 18—not for the whole of their 18 years, but at one point or another. Their mother or their father will not be able to support them and they are going to be on public assistance.

That is a strange condition for a country, that whatever else it is, is a prosperous country.

Alongside that development, we have looked at the tax system. We find something very important. If you go back 37 years to 1948, you will find that the income tax almost began with the proposition that, if you were raising a family, you ought to pay very little tax until you got an income well past the median. You started to pay taxes there.

The numbers have changed because of inflation. It may not seem as large as it was. But in 1948, the child exemption, what we call the personal exemption, was $600. That meant that the standard Bureau of Labor Statistics family of four got four $600 exemptions, plus the $267 standard deduction, and their threshold for Federal income taxation was $2,667. This means that more than three-fourths of median family income in 1948 was exempt from Federal tax.

That situation has almost completely disappeared today. In 1983, the median family income for a family of four was $29,184 and the Federal income tax threshold reached $8,783. At a third of the

median income you start paying taxes. We tax people with incomes below poverty.

The most striking and the central point and the only one I would want to make is what has happened to that $600 personal exemption. You mentioned that if indexed for inflation, its value today would be $2,600. However, there's another way to look at this, which an economist named Eugene Steuerle has done. He is at the Treasury now. In 1948 the $600 personal exemption offset on the average 42 percent of per capita income. If you took 42 percent of per capita income today, the personal exemptions would amount to $5,600. In relative terms, you would not begin to pay income tax today until you had an income of about $26,110 (assuming the current zero bracket amount for a couple of $3,700).

That was the tax code that was in place 37 years ago. And we have just let it slip away from us by not paying attention to the subject you have raised, which is tax fairness to families.

You have to begin there. This is central. We once had a tax code which provided for the traditional family situation in which adults were working and children were going to school. Today this is an impossible situation.

Today, after 37 years of economic growth, we would find that, if we looked up the largest number of poor people in our country, they are our children.

[The prepared statement of Senator Daniel Patrick Moynihan follows:]

PREPARED STATEMENT OF SENATOR DANIEL PATRICK MOYNIHAN

Madame Chairman: Thank you, and members of the Committee, for asking me to appear before you today to discuss the taxation of families. I had the great privilege of addressing this very matter recently at Harvard University, in the Godkin Lectures.

Madame Chairman, problems concerning the tax treatment of families—and especially working families—have received much attention of late, but they are not new. In 1972, then-Governor of California, Ronald Reagan, appeared before the Senate Finance Committee to testify about the tax burden on poor working families, and the need to reduce it:

"Many fully employed families work for compensation which is insufficient to meet their minimum needs. This becomes more severe as the size of the family increases. Because they are fully employed, they are ineligible for the AFDC programs. Rather than create a new category of welfare recipients, it is proposed that the situation of such low-income families be improved by providing automtic exemptions from state and federal income taxes and an automatic rebate of social security taxes including the employer's contribution thereto. The solution concerning these families is to provide a better return for their efforts through such exemptions and rebates rather than place them on public relief unrelated to their work efforts and productivity."

In 1975 a Democratic Congress and a Republican President, Gerald Ford, did as much as Mr. Reagan had proposed, enacting the Earned Income Tax Credit of that year. Under that Act, low-income working families with children can claim a tax credit or, if their income is low enough, receive a cash payment of up to $550 a year. By this decade, between six and seven million families were receiving benefits from this provision, amounting to just under $2 billion a year. About one-third, received in the form of reduced taxes; two-thirds, in cash payments.

The Treaury tax reform plan addresses the tax treatment of low-income families, and directly. It was natural enough for the Administration in 1984 to pursue the strategy Mr. Reagan had outlined in his testimony of the previous decade. In his 1985 State of the Union address, Mr. Reagan had declared that tax reform would be a primary objective of his second term. Along with many other things, this tax proposal would increase the personal and dependent exemptions to $2,000, and modestly raise the "standard deduction." (This would increase the exemption from the cur-

rent base of $1,040. The 1981 tax act had finally indexed it, starting in 1985.) This was a modest enough proposal.

The personal and dependent exemptions in the income tax were introduced in 1913 and 1917, respectively. Each taxpayer exempts from taxable income a certain amount for himself or herself and for each remaining member of the household, including children. The "typical" tax return for a husband-wife family, then claims four exemptions. The dependent exemption is, in a sense a children's allowance built into the tax code, as much as AFDC payments are (and originally were) children's allowances build into the Social Security System. In 1948 the exemption was $600, at which time it amounted to 42 percent of average per capita personal income, Eugene Steuerle, of the Treasury Department, has calculated that "(i)f the personal exemption had been indexed for income growth since 1948—in other words, if the exemption were to offset the same percentage of per capita personal income today as it did in 1984—then it would equal . . . about $5,600 in 1984 . . ." By 1984, the exemption had increased only to $1,000. Alternatively, if the exemption had been indexed for increases in the Consumer Price Index, the $600 exemption in 1948 would have been a $2,589 exemption in 1984. Steuerle concludes: "By any measure this decline in the personal exemption has been the largest single change in the income tax in the post war era."

It is a straight forward matter to extend this analysis from individuals to families. In 1948, the median income for a family of four was $3,468, and the threshold for Federal income taxes was $2,667 (the $600 presonal exemption times four, plus the $267 standard deduction). This means that more than three-fourths of median family income in 1948 was exempt from Federal tax.

This is a powerful national family policy by any measure; it costs much to raise a family, and the Federal Government chose not to tax most of the income so required. No longer. In 1983, the median income for a family of four was $29,184 and, according to the Joint Committee on Taxation, the Federal Income tax threshold had reached $8,783—which means that less than one-third of median family income was exempt.

It may well be that in more than three decades of respectable economic growth, median income grew faster than the costs of raising a family, but just as surely not that much faster. The point here is that the costs of raising a family no longer bear any relationship to the amount of income not subject to Federal tax. This relationship is so askew that a poor family—not just of median income, but one below the poverty line—is subject to tax. In 1948 the poverty line for a family of four would have been $2,454, or some $200 below the income tax threshold. In 1983 the poverty line was $10,166 for a family of four, but Federal tax liability in that year began at $8,783, or some $1,400 below the poverty level. Two decades after the enactment of the Economic Opportunity Act, the Federal Government is taxing the poor at levels without equal in history.

What we see here is the "flattening" of the tax system. In 1948 the income tax was highly progressive, with marginal rates upwards of 80 percent on upper-income families (rising higher still, to 92 percent, in 1952) and little or no tax whatever levied on low-income families. This slowly changed. Marginal rates came down, to 70 percent in the mid-1960s and 50 percent in 1982. Meanwhile, inflation pushed more and more low-income families into the taxable range, principally because the value of the personal and dependent exemption was not maintained. In the meantime the Social Security tax, which begins with the first dollar of earned income, rose steadily. In 1948, this tax claimed 1 percent of the first $3,000 of earnings; in 1985, 7.05 percent (of the first $39,600). All told, combining Federal income and social security taxes, an American family of median income in 1948 paid about 4.4 percent of its income to the Federal Government. By 1982, the Federal Government was claiming some 18 percent of the median family's income.

The Treasury's tax proposal to double the exemptions to $2,000 each, would cost $40 billion a year, something like 10 percent of all revenues from the personal income tax. This is a formidible sum; yet it is also a measure of the extent to which the tax system has shifted against low- and moderate-income families in the postwar years.

What would change if this shift were now reversed? No one knows, Curiously, this is where the consideration of family policy must begin. We do not know the processes of social change well enough, so as to be able confidently to predict them; far less to affect them. What we do know is what we generally value as a society, and what we generally think is conducive to the things we value. We value self-sufficiency. We are offended by poverty. It follows that we should not tax individuals, much less families, to the point where they are officially poor and potentially dependent. We now do that. This is a matter on which we can agree. Do not tax people into pover-

ty. Do not tax them below their family's needs. To do so, we would not so much be changing things as restoring what was once in place, remembering answers we once thought obvious.

Mrs. SCHROEDER. I thank you. I think those are very sobering thoughts.

I think the question that we have becomes how do we turn that around? I am sure that you find on your side the same thing we find here. When you talk about increasing the personal exemption, they start screaming revenue loss, revenue loss, revenue loss.

We really have pushed more and more and more the tax burden on the middle class. We now see them even talking about taxing fringe benefits, which I think would really impact the families.

Senator MOYNIHAN. I would say, Madam Chairman, that, in response to the question of what it is going to cost, one answer is, what have we allowed to happen? Of course the number is large. If you were to just index this exemption for inflation, as you suggested, it would cost you more than $40 billion. Well, it is a big chunk. How come we let it happen?

Obviously, we have found a way of taking away from children and we passed it on to race horses. Well, you can raise race horses, you're absolutely right, you can make money raising race horses. Just take them off your income tax. They are a capital gain. Maybe that's what we should do: declare children as a capital gain and buy and sell them.

The only point which I would wish further to make to you is this. The single largest change in the income tax system since World War II has been the near disappearance of the personal exemption in the Tax Code for children.

Mrs. SCHROEDER. That is very, very sobering.

I wanted to ask another question. Would you tolerate the following? I feel very strongly about raising the personal exemption, at least $2,600. And I think you make a very good point: if we are really serious, we should do $5,600. I just don't know if we could go that far.

One of the criticisms you get is that you still have not solved the problem for the lowest of the low income. Would you allow people to sell that, as you allow corporations to sell an excess? In other words, if you are an AFDC mother and you have more exemptions than income, what could you do to make up the difference?

I think the middle class has got a terrible problem, too. We have really about wiped out the middle class if they have children, in a way; you have to redefine it. And there we are talking about the policeman who makes $28,000 and cannot send his children to school and feels he has lost his dignity. I mean, those are the kinds of letters we are all getting.

But what would you do about the lowest income families, for whom an increased personal exemption may not make a very big difference?

Senator MOYNIHAN. Well, it would, to the degree that you are talking about that one child in three who is going to be on AFDC. It would help us a lot if we kept in mind that AFDC is part of the Social Security Act. It is a Social Security entitlement just as disability insurance is, and survivor's insurance is, and retirement is. Yet, we have indexed everything, every benefit that comes out of our social insurance arrangements in this country, for the aged, for

the disabled, for the veterans, for the civil servants, for the retired. You name it, it's been indexed—excepting that provision for children. Only the children are left out.

We have been hearing all this talk about the explosion of welfare costs in the 1970's. There wasn't any. The benefits under the AFDC program, for children, in real terms declined 37 percent between 1970 and 1985. You know, you nearly cut it in half. You didn't have to use scissors. You just didn't do anything. Just as with the personal exemption, just don't do anything, and it erodes.

Obviously, we should have a national standard of payment under Social Security for children. And obviously it should be indexed. And if you don't do it, you look up after four decades of real economic growth and you find about a fifth of your children at any given moment, indeed at this moment, live below the poverty level. Twenty-one percent of school-aged children are poor.

Fifty percent of children born in 1980 will live with one parent before they are 18. Thirty-two percent will be on AFDC—which is Social Security—before they are 18. I wish AFDC would stop being called welfare, as if welfare has been made illegal, immoral, or whatever. The people who wrote the Constitution didn't think so, but people who got elected might.

Mrs. SCHROEDER. They used to talk about the general welfare as though it was something good.

Senator MOYNIHAN. Promoting it.

Mrs. SCHROEDER. One way to truly promote the general welfare and move families off welfare, would be to increase the personal exemption to the full $5,600 for use you cited earlier. Then give families the same opportunity as corporations, so that those families who have more exemptions than income could sell their excess. This would be analogous to corporations selling their excess tax writeoffs to other corporations.

Senator MOYNIHAN. I say try it. Pass it over here and send it to us.

Mrs. SCHROEDER. You could create a whole new thing and probably get rid of welfare. Everybody could go out and hustle their own exemption sales.

We really do appreciate your coming.

Congressman Lehman, do you have any questions?

Mr. LEHMAN. I have no question. I certainly appreciate Senator Moynihan coming.

I have an article, which you probably read, that deals with taxes in the Economist, in regard to an increase in the diesel gas tax.

Senator MOYNIHAN. Yes, sir.

Mr. LEHMAN. Have you read that?

Senator MOYNIHAN. I have, sir.

Mr. LEHMAN. I am very impressed with that as a way to really cut the deficit. Would you care to comment on the article?

Senator MOYNIHAN. Well, I think if ever there has been a time to increase energy taxes, it is now. If we don't do it, you know what we are going to get, don't you? We are going to get another fleet of

old gas guzzlers that we are going to have to use. It is kind of a capital investment. You think of a country buying a new fleet of cars. If they buy cars that get 12 miles a gallon, which they think they can do now, and then the price of gasoline is going to double, and everybody is going to be mad at each other again.

It would be a good idea. Why don't you talk to the Secretary of the Treasury? I am sure he would be interested. You know, he wouldn't——

Mr. LEHMAN. Thank you, Senator.

Mrs. SCHROEDER. We thank you very much for being here.

I was going say that this all happened because children can't vote, but I guess race horses can't either. So, I guess we have to find a new reason for why all this transpired.

Senator MOYNIHAN. Even though you can make more money on race horses than you can on children——

Mrs. SCHROEDER. Absolutely, no question. Thank you very, very much, Senator.

Even if they don't win the race, you can make more money.

We now have a very distinguished panel that we are very honored to have with us this morning. Congressman Kemp was to be here, but because of the Republican conference going on, he has put his remarks in the record.

[Prepared statement of Congressman Jack Kemp follows:]

PREPARED STATEMENT OF HON. JACK KEMP, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

KEMP-KASTEN AND THE FAMILY

Madam Chairman and members of the Select Committee on Children, Youth, and Families, I appreciate this opportunity to testify about tax reform and the American family, and particularly about the effect of the Kemp–Kasten "Fair and Simple Tax" (H.R. 777, S. 325) on families.

When Senator Kasten and I first introduced Kemp-Kasten last year, one of our chief concerns was to design a tax system that was pro-family. A major flaw in the current code is its strong bias against investment in human capital. Over the years we have put in all kinds of tax loopholes to protect various groups from raising tax rates—but not the traditional family.

In many respects, Kemp-Kasten was guided by asking how tax reform would affect the traditional family of modest means trying to raise children. We also wanted to protect senior citizens, the working poor, single people and two-earner couples, after all, a family doesn't stop being a family when the children grow up and the parents grow old.

With the family in mind, three of Kemp-Kasten's features are especially important:

First, there is a flat 24 percent tax rate on taxable income.

Second, we double the personal exemption to $2,000 for each taxpayer, spouse, and dependent (as well as the extra exemption for the elderly, blind and disabled).

Third, there is a new exclusion: in general, people can exclude 20 percent of their wages and salaries up to the amount on which they pay Social Security tax. The exclusion is phased out by adding back 20 percent of income in excess of the maximum Social Security wage base. This exclusion lowers the effective and marginal income tax rates on low to middle-income Americans and helps offset the Social Security payroll tax, resulting in a smooth, almost flat total tax rate.

We also retain the current deductions for mortgage interest, real property taxes, charitable contributions and catastrophic medical expenses, as well as the tax deferral of all kinds of retirement savings. We keep the exclusion for employer-provided health and life insurance. Many of the other tax preferences in the tax code are eliminated.

Kemp-Kasten also keeps indexing, which is especially crucial to lower and middle-income taxpayers so that they are not forced to bear higher tax burdens because of inflation-induced "bracket creep." Under Kemp-Kasten, the personal exemption,

zero bracket amounts, employment income exclusion, and the earned income tax credit are all indexed for inflation.

Let me explain these advantages by considering their effect on various taxpayers.

Families with children.—The drastic erosion of the personal exemption by inflation has caused taxes to rise almost twice as fast for families with children as for other taxpayers since World War II. Back in 1948, the personal exemption was $600; in constant dollars, it has shrunk to only $137, or to about one-fifth of its value almost 40 years ago. If the personal exemption has been indexed for inflation since 1948, it would be more than $2,500 today. Instead, it is only $1,040.

The value of the personal exemption depends not only on its size, but also on the nature of its deductibility. For example, the same $1,040 exemption under current law is worth $114 in the bottom tax bracket, but $520 in the top tax bracket.

The Bradley-Gephardt tax proposal increases the exemption for adults to $1,600, but reduces the exemption for dependent children from $1,040 in 1985 to $1,000 in 1986. Because of the higher bottom tax rate, the value of the exemption for each child rises from $114 to $140 a year, though Bradley-Gephardt repeals inflation-indexing. Since the Bradley-Gephardt plan allows the exemption only against the 14 percent bottom tax rate, the exemption is worth $140 for all taxpayers, including those in the 26 percent and 30 percent tax brackets. This represents a reduction of the tax value for the exemption in the top bracket from $520 to $140.

The personal exemption is worth $2,000 and indexed for inflation under both Kemp-Kasten and the Treasury plan. But because of the different rate structures, the effect of the $2,000 exemption is different under the Treasury plan than under Kemp-Kasten.

Under the Treasury plan, with tax rates of 15 percent, 25 percent, and 35 percent, the value of each exemption rises from $114 to $300 in the bottom tax bracket, and from $520 to $700 in the top tax bracket. Under Kemp-Kasten, all exemptions, deductions, exclusions, etc. are worth 24 cents on a dollar. Therefore, the value of each child exemption for a low-income family more than quadruples, from $114 to $480 a year. At high incomes the value of the exemption remains about the same, $480 compared with the current $520. The increased value of the child exemption under Kemp-Kastenm is concentrated at middle and low incomes where it is most needed.

The working poor.—Right now, families living in poverty pay rather stiff rates of federal income tax. While the 1981 tax rate reductions helped to slow down the rising tax burden on the poor, high inflation and sharp increases in the Social Security payroll tax—the most regressive of all taxes—during the late 1970s hit the working poor especially hard.

Much of the worst impact of inflationary bracket creep has been felt by low-income families, who used to be exempt from income tax but have been swept on to the tax rolls by inflation. The poverty level in 1985 is $11,101 for a family of four (it probably will be more than $11,500 next year), while the income tax threshold for a family of four is $7,700 (or $9,436 including the earned income tax credit). The tax disincentives are compounded because in many cases the disposable income obtainable through transfer payments for not working is almost as great as or even greater than after-tax wages at a comparable income. This is the famous "poverty trap."

Kemp-Kasten addresses this problem in several ways. One way is to raise significantly the tax-free threshold of income. The income tax threshold for a family of four is raised to $11,800 under the Treasury plan, and $11,500 under Bradley-Gephardt. But under Kemp-Kasten, the tax-free level of income for a family of four is raised to $14,125. For a single taxpayer, the income tax threshold is $5,750 under Kemp-Kasten, compared with $4,800 under the Treasury plan, $4,600 under Bradley-Gephardt, and $3,430 under current law. Kemp-Kasten also raises the income tax threshold for a retired couple from $7,700 to $14,125, and for a retired single person from $4,470 to $8,250. The income tax threshold for a single parent with two dependents is increased from $8,375 to $10,750. This removes about 1.5 million of the lowest-income taxpayers from the tax rolls, and indexing will keep them off the rolls for as long as they are poor.

Another Kemp-Kasten change which cuts high effective marginal tax rates at low incomes is to modify the earned income credit. Under current law, the earned income credit is 11 percent of earned income up to $5,000. The maximum credit of $550 is phased out by reducing the credit by 12⅝ percent of income in excess of $6,500. This makes the credit disappear at $11,000. Phasing out the credit adds a marginal tax rate of 12⅝ percent to the usual tax rate; and since the bottom income tax brackets overlap the phaseout range of the earned income tax credit, this can result in fairly high effective marginal tax rates at low incomes, under current law and under the other tax reform plans. For example, a single head of household earning $10,000 with one dependent faces a marginal income tax rate of 26 percent

under current law and under Bradley-Gephardt, and 27 percent under the Treasury plan, plus the 7 percent payrolld tax rate and the 50%-75 percent effective marginal tax rates from foregoing transfer payments.

Kemp-Kasten reduces these effective marginal income tax rates by coordinating the earned income credit and the normal income tax thresholds. We increase the credit from 11 percent to 15 percent, thereby increasing the maximum credit from $550 at $5,000 to $600 at $4,00, to benefit the most disadvantaged households. We phase out the credit completely at $8,000—just below the $8,250 tax threshold for a single head of household—in order to end the overlapping which causes the spike in effective marginal tax rates. This reduces effective marginal income tax tax rates on the working poor by about 25 percent below current law and the other tax reform plans. Kemp-Kasten also indexes the earned income credit for inflation, for the first time, to help protect the poor from paying higher taxes because of inflation-driven increases in income. Of course, we realize the importance of the earned income credit for lower income families and are always looking for ways to ensure that it truly benefits low-income households.

Important as the "poverty trap" is, cutting high effective marginal tax rates alone will not magically cure poverty. The more we understand about the causes of poverty, the more we are drawn to the conclusion that it has at least as much to do with the stability of families as with after-tax income. While this question goes far beyond the realm of tax policy, I believe that the "pro-family" aspects of Kemp-Kasten should be considered as an integral part of its anti-poverty strategy.

Wage-earners.—For many years upper-bracket taxpayers faced a higher tax rate on investment than on employment income. This distinction was removed in the 1981 tax bill. However, there still exists a distinction between labor and capital income at middle and lower incomes. Under current law (and the other tax reform plans) the payroll tax is added on top of the personal income tax rate for labor income, but not for capital income. Therefore, the tax rate on workers is higher than the tax rate on savers. This is true under current law and under all tax reform plans other than Kemp-Kasten.

Since the payroll tax base stops at about $40,000, the marginal tax rate on labor income can be higher at lower income levels than on upper-income taxpayers, under both current law and the other tax reform plans. Viewed by income level, the combined marginal tax rate structure above the income tax threshold behaves as follows. Under current law, the tax rate starts at 18 percent, rises to 41 percent, falls to 34 percent, then rises to 50 percent. The tax rate under Bradley-Gephardt starts at 21 percent, rises to 37 percent, then falls to 30 percent. The Treasury plan tax rate starts at 22 percent, rises to 42 percent, then falls to 35 percent. Under Kemp-Kasten, the income and payroll tax rates are coordinated, so that the tax rate starts at 26 percent for labor income, 24 percent for capital income, and ends at 28 percent for both.

More family issues.—Kemp-Kasten seeks to equalize the tax treatment among families in several ways. Both Bradley-Gephardt and the Treasury plan repeal the child care credit and replace it with a deduction for child-care expenses, which generally helps only two-earner families with children below school age. Kemp-Kasten repeals the credit and devotes the extra revenue, in effect, to helping all families with children by increasing the personal exemption. Compared with current law, this helps one-earner families with children more than two-earner families; but in general the Kemp-Kasten treatment is absolutely more favorable for all low- and moderate-income families than either Bradley-Gephardt or the Treasury plan.

For example, a family of four earning $15,000, with the second spouse earning a third of the income and child care expenses totaling 10 percent of the family's total income, pays federal income tax in 1986 of $393 under current law, $475 under Bradley-Gephardt, $419 under the Treasury plan, and $168 under Kemp-Kasten. With only one earner and no child care expenses, the federal tax is $868 under current law, $532 under Bradley-Gephardt, $480 under the Treasury plan, and $168 under Kemp-Kasten.

In this way, Kemp-Kasten equalizes the treatment of families with children, regardless of their parents' employment status. Any other approach seems to imply that the effort of the parent who stays at home to care for the children is worth less than if he or she worked outside the home. It does not seem fair to recognize the expense of earning a second income, but ignore the cost of giving up a second career, which often goes with the decision of a spouse to remain at home to raise the children.

At the same time, Kemp-Kasten removes a bias against two-earner couples, which exists under current law and the other major tax reform plans. A two-earner family with combined wages in excess of the Social Security payroll tax base pays a higher

Social Security payroll tax and therefore a higher combined marginal tax rate than other taxpayers on the same income. Under Kemp-Kasten, two earner couples may figure out their 20 percent wage exclusions separately and add the two, if this results in a larger total exclusion. This offsets 5 of the 7 percentage-point increase in the combined marginal tax rate that occurs under current law and the other tax reform plans. In a sense, then, the Kemp-Kasten wage exclusion acts like a second-earner deduction for married couples.

CONCLUSION

Madam Chairman, we must act now on a comprehensive reform of the federal income tax. We need such a reform in the interests of fairness, simplicity, and economic growth. I would urge this committee to examine the approach we have taken in Kemp-Kasten, and itsw advantages for families with children, the working poor, and others.

The American family is the foundation of our society, and I believe that any tax reform plan will ultimately be judged on how well it helps American families in their daily lives to fulfill their hopes through their own efforts. We cannot have real tax reform and ignore our best and brightest investment—our children. Our children are our hope for the future—a promise that another generation will carry on the dreams and aspirations that we all share.

Children and the poor really have no high-powered lobbying firm to look after their interests. We must ensure that tax reform meets their needs and hopes for the future. I am heartened by the bipartisan nature of this concern and awareness of the family's importance. In discussing the fate of this deduction or that credit, I hope that we all keep in mind the needs of the American family. I look forward to working with this committee to meet this challenge.

Thank you.

Mrs. SCHROEDER. We have Mr. Joseph Minarik. I hope I pronounced that correctly. He is the senior research associate at the Urban Institute. Alvin Schorr is the Leonard W. Mayo Professor of Family and Child Welfare at Case Western Reserve University in Cleveland, OH. Robert Carleson is the director of government relations at KMG Main Hurdman, Washington, DC.

Marian Wright Edelman is from the Children's Defense Fund. I am not sure if Marian is here. Are we ahead of schedule on everybody? As I say, we learned that many members of the select committee would not be able to attend this hearing at 10 o'clock last night.

Mr. WEILL. I am Jim Weill from the Children's Defense Fund. I think Ms. Edelman thought she was going to testify after this panel, and she is probably going to be here between 10:00 and 10:15.

Mrs. SCHROEDER. OK, well, we will go ahead with the panel of three. I am sure they have plenty to say.

We welcome all of you. We will put your statements in the record.

If I butchered your name, I apologize profusely. Please identify yourself. Which way would you like to start? It's up to you, whoever wants to kick off. Do you want to flip coins?

Mr. SCHORR. How about alphabetically?

Mrs. SCHROEDER. OK. Let's do it by alphabet. That means Mr. Carleson can lead off, if that's all right.

STATEMENT OF ROBERT B. CARLESON, DIRECTOR OF GOVERNMENT RELATIONS, KMG MAIN HURDMAN

Mr. CARLESON. Madam Chairperson, members of the task force, I am Robert Carleson, one of Washington's formers: former Special Assistant to President Reagan for Policy Development; former U.S.

Commissioner of Welfare; former director of the California Department of Social Welfare; and former professional city manager. At present I am a principal and director of government relations for KMG Main Hurdman, part of a transnational public accounting and consulting firm.

My subject today is the earned income tax credit, the EITC. I might say that probably you will hear that phrase quite a bit. The EITC, which is one of the more obscure parts of the tax law, although a very important part, had its genesis on February 1, 1972, when then-Governor Reagan testified before the Senate Finance Committee in opposition to President Nixon's family assistance plan. It was my privilege to accompany the Governor at the witness table on the single occasion he testified before Congress during his 8 years in office in California.

He and I believed then and do now, I am sure, that the working poor with children, the intended beneficiaries of the family assistance plan, would benefit most by relief from the income tax and a rebate of the employee-employer paid payroll tax rather than make them dependent on public aid unrelated to their work efforts.

Subsequently, with the backing of Senator Russell Long, the Congress did raise the level of income which a family could earn before income tax is assessed, and created the earned income tax credit as an indirect means of achieving the goal of refunding the employee-employer payroll tax. The earned income tax credit avoided the problems of a direct refund of the payroll tax which would severely disrupt the earnings record/retirement benefit relationship of the Social Security system, and would be too complex to administer.

The EITC was originally a refundable credit of 10 percent of earned income for families with children for the first $4,000 per year of income. It phased out at the rate of 10 percent over the next $4,000 of annual earned income. No credit was available after $8,000 of annual earned income.

The rationale for the 10 percent was that that figure was the approximate combined employee-employer payroll tax in 1972.

The rationale for the phaseout was to avoid a situation where a small increase in income would result in a loss of refundable credit greater than the increase in income, which is called a notch.

I might say at this point that a notch should be remembered as a small increase in income which would result in losing all or a large part of the benefit.

Later in the 1970's, I worked with Senator Long to develop an improvement in the EITC which would reduce the phaseout period and establish the principle of a plateau, which is a period of increased income where the total credit neither increased nor decreased. Our goal eventually was to eliminate the phaseout, which creates a high marginal tax rate over an extended period of time.

I believe that a sudden end to the credit, a notch, in other words, is actually less a disincentive to increased work effort than is a long phaseout affecting many more people. I might say that most theoretical economists have a different opinion, but I believe that in the real world I am correct. Our experience with the results of the 1981 national welfare reforms, I contend, confirms my view.

The way this works is that most promotional opportunities in the real world are not available to everyone. There is only one lead-

man or leadwoman or one supervisor in each group of workers. I believe that there will be more than enough persons willing to take a promotion leading to future career success, even though such a promotion would result in the immediate loss of the EITC. By accepting this notch, we are then able to avoid the high marginal tax rate effects of a long phaseout of the EITC which would affect millions of people over a long period of time.

Another advantage of eliminating or limiting the phaseout is that it is very costly. And I might add, Madam Chairman, as you indicated in your opening remarks, one of the problems we have in raising any of these benefits is the high cost. We can realize that to the extent that we can reduce costs in areas which affect the higher income people in that particular group, we have more funds available for the lower income people.

So, we could free up funds to improve the EITC for lower income workers if we, in effect, eliminated or limited the phaseout period and accepted the notch. Senator Long in conversations with me characterizes this notch as just a missing rung on a ladder which a worker can overcome by reaching up to the next rung.

As a result of Senator Long's amendments, referred to above, the current EITC is a 10-percent refundable credit for the first $5,000 in annual earned income for families with children. The next $1,000 in income results in no increase or decrease in the total credit, which is $500, which is the plateau. The credit then phases out, or diminishes, at the rate of 12.5 percent through the next $4,000 of income. It is totally phased out at $10,000.

The advantages of the EITC, and its characteristics are that it has an automatic work requirement. I might say that the EITC is just about the only program where the Federal Government could administer a work requirement successfully.

It has "no earned income, no refundable credit."

Over the first phase, the more you work, the more you get, unlike the family assistance plan, child allowances or guarantees income plans, where a family gets the full amount for not working.

It has the effect of refunding a tax, Social Security in this case, rather than being a new means-tested welfare program for the working poor.

And, as Senator Moynihan pointed out, the nonworking poor with children are provided for under AFDC, food stamps and other appropriated programs, while the earned income tax credit is tax relief.

Now, what are the defects in the current earned income tax credit system?

First of all, it does not reflect the current employee-employer payroll tax rate, which is about 14.5 percent.

The phaseout period, between $6,000 and $10,000 of income is a high marginal tax rate over a long period and therefore affects many people over a long time and is very costly.

Three, there is no provision for the number of children in the family. Whether there is one child or four, the credit ends at the same income level.

I believe that it is imperative that the tax system be just that, a tax system to treat earnings and incomes of people who are working or who have other income. Welfare for nonworking families

should be provided through AFDC, food stamps, and other appropriated programs, and I might add also for those families who are working but whose income falls below the levels of eligibility for those appropriated programs.

The Federal tax system affecting low-income working families consists of the income tax and the payroll tax. Relief from both taxes can be effected through the income tax system:

By raising again and indexing the level of income which a family can earn before the income tax is assessed, as was first recommended by then-Governor Reagan in 1972 and enacted thereafter by the Congress.

Two, raising the percentage of the EITC to match the current combined employee-employer Social Security tax, which is now about 14.5 percent, and indexing it to future increases in that rate.

I might indicate that this would be a 45-percent increase in the EITC benefit, in other words a minimum increase.

And then introduce a new per-child aspect to the EITC by basing earned income subject to the credit on the number of children in the family.

As an example, simply an example, for a family with one child, the full credit to $5,000 of earned income, which is now the system for families with any number of children.

For a family with two children, the full credit to $6,000 of earned income.

For a family with three children, the full credit to $7,000 of earned income.

And for a family with four or more children, the full credit to $8,000 of earned income.

And then I would suggest in this example phaseout of all credits at $12,000, above the poverty level for a family of four. Frankly, I would prefer an alternative that accepted the notch effect with no phaseout as argued earlier in my paper. If you did that, you might be able to increase some of these earlier benefit levels on the way up, in the first part of the example.

I would rather accept a rapid phaseout than be side-tracked into the argument over the notch and its effect on the work incentive which would delay agreement on an improvement in the earned income tax credit.

And then, of course, I would suggest that we raise the dependent exemption for families subject to the income tax. But I was asked to testify primarily on the earned income tax credit.

I presume that financing for the EITC portion of this proposal could be effected in an overall tax package through adjustments in the amount of the increase in the personal exemption or by limiting the increase in the exemption to dependents only. In any event, the cost of improving the EITC can be reduced significantly by accepting my thesis that at these levels of income the disincentive effects of a notch are offset by other factors and the incentive for working people to achieve career success.

This thesis has been validated by numerous studies of the effects on the working poor of the 1981 Reagan welfare reforms as reported by Nicholas Lemann in the September 1984 issue of the Atlantic, on pages 38 to 40.

In conclusion, the working poor with children again need tax relief as was urged by then-Governor Reagan and adopted by the Congress in the early and mid-1970's. Since that time, inflation and increases in the payroll tax have eroded those benefits.

By increasing and indexing the EITC to match the combined employee-employer payroll tax rate and increasing and indexing the income levels to which the credit can be applied on the basis of the number of children in the family, we can maintain the integrity of the EITC as a form of tax relief and recognize that need for tax relief increases with increases in family size. Benefits from the credit will be earned benefits. And I think this is very important. It wouldn't be welfare. These people would be receiving that as earned benefits. Families will be refunded the payroll tax paid by them or on their behalf as a result of their work.

Increasing and indexing the dependent exemption and the level of income at which the income tax is levied will provide needed relief from the income tax for the working poor and near poor.

Precise levels of income to be affected by these recommended changes can be determined within the context of the various tax simplification proposals pending before the Congress and the administration, but tax relief for low-income families, in my opinion, should have a high priority.

Thank you, Madam Chairwoman, for permitting me to present my views to your committee.

Mrs. SCHROEDER. Thank you very much, Mr. Carleson.

We will proceed by alphabetical order. I hope I pronounced your name right.

Mr. CARLESON. Excuse me. I forgot to ask that my statement be in the record.

Mrs. SCHROEDER. Without objection, we will put everybody's full statement in the record.

[Prepared statement of Robert B. Carleson follows:]

PREPARED STATEMENT OF ROBERT B. CARLESON, PRINCIPAL AND DIRECTOR OF GOVERNMENT RELATIONS, KMG MAIN HURDMAN

Madam Chairman, members of the Committee, I am Robert Carleson, one of Washington's "formers". Former Special Assistant to President Reagan for Policy Development. Former U.S. Commissioner of Welfare. Former Director of the California Department of Social Welfare and former professional City Manager. At present I am a Principal and Director of Government Relations for KMG Main Hurdman, part of a trans-national public accounting and consulting firm.

My subject today is the Earned Income Tax Credit (E.I.T.C.). The E.I.T.C. had its genesis on February 1, 1972 when then Governor Ronald Reagan, testified before the Senate Finance Committee in opposition to President Nixon's Family Assistance Plan. It was my privilege to accompany the Governor at the witness table on the single occasion he testified before Congress during his eight years in office in California.

He and I believed that the working poor with children, the intended beneficiaries of the Family Assistance Plan, would benefit most by relief from the income tax and a rebate of the employee-employer paid payroll tax rather than make them dependent on public aid unrelated to their work efforts.

Subsequently with the backing of Senator Russell Long the Congress did raise the level of income which a family could earn income tax is assessed, and created the E.I.T.C. as an indirect means of achieving the goal of refunding the employee-employer payroll tax. The E.I.T.C. avoided the problems of a direct refund of the payroll tax which would severely disrupt the earnings record/retirement benefit relationship of the Social Security system, and would be too complex to adminster.

The E.I.T.C. was originally a refundable credit of 10 percent of earned income for families with children for the first $4,000 per year of income. It phased out at the rate of 10 percent over the next $4,000 of annual earned income. No credit was available after $8,000 of annual earned income.

The rationale for the 10 percent was that that figure was the approximate combined employee-employer payroll tax in 1972.

The rationale for the "phase-out" was to avoid a situation where a small increase in income would result in a "loss" of refundable credit greater than the increase in income (a "notch").

Later in the 1970's. I worked with Senator Long to develop an improvement in the E.I.T.C. which would reduce the phase-out period and establish the principal of a "plateau" (a period of increased income where the total credit neither increased nor decreased). Our goal, eventually, was to eliminate the "phase-out" which creates a high marginal tax rate over an extended period to time.

I believe that a sudden end to the credit (a notch) is less a disincentive to increased work effort than is a long phase-out affecting many more people. Most theoretical economists have a different opinion, but I believe that in the "real world" I am correct. Our experience with the results of our 1981 Welfare Reforms, I contend, confirms my view.

Most promotional opportunities are not available to everyone. There is only one leadman of leadwoman or one supervior in each group of workers. I believe that there will be more than enough persons willing to take a promotion leading to future career success, even though such a promotion would result in the immediate loss of the E.I.T.C. By accepting this "notch" we then are able to avoid the high marginal tax rate effects of a long phase-out of the E.I.T.C. which would affect millions of people over a long period of time. Another advantage of eliminating or limiting the phase-out is that it is very costly and eliminating it can "free up" funds to improve the E.I.T.C. for lower income workers. Senator Long in conversations with me characterizes this "notch" as a "missing rung on a ladder" which a worker can overcome by "reaching up to the next rung".

As a result of Senator Long's amendments, referred to above, the current E.I.T.C. is a 10 percent refundable credit for the first $5,000 in annual earned income for families with children. The next $1,000 in income results in no increase or decrease in the total credit ($500). The credit then phases out (diminishes) at the rate of *12½ percent* through the next $4,000 of income. It is totally phased out at $10,000.

Advantages of the E.I.T.C:

What then are the advantages and characteristics of the E.I.T.C.?

It has an automatic work requirement. No earned income—no refundable credit.

Over the first phase, "the more you work the more you get"; unlike the F.A.P., child allowances or guaranteed income plans, where a family gets the full amount for not working.

It has the effect of refunding a tax (social security) rather than being a new means-tested welfare program for the working poor.

The nonworking poor with children are provided for under A.F.D.C; food stamps and other appropriated programs. The E.I.T.C. is tax relief.

Defects in the Current E.I.T.C:

It does not reflect the current employee-employer payroll tax rate which is about 14.5 percent.

The phase out period, between $6,000 and $10,000 of income is a high marginal tax rate over a long period and therefore affects many people over a long time, and is very costly.

There is no provision for the number of children in the family. Whether there is one child or four the credit ends at the same income level.

RECOMMENDATIONS

I believe that it is imperative that the tax system be just that, a tax system to treat earnings and income of people who are working or who have other income. Welfare for non-working families should be provided through A.F.D.C., food stamps and other appropriated programs.

The federal tax system affecting low income working families consists of the income tax and the payroll tax. Relief from both taxes can be effected through the income tax system by:

Raising again and indexing the level of income which a family can earn before the income tax is assessed as was first recommended by then Governor Reagan in 1972 and enacted thereafter by the Congress.

Raising the percentage of the E.I.T.C. to match the current combined employee-employer Social Security tax (about 14.5 percent) and indexing it to future increases in that tax rate.

Introduce a "per child" aspect to the E.I.T.C. by basing earned income subject to the credit on the number of children in the family.

Example:

For a family with one child, the full credit to $5,000 of earned income.

For a family with two children, the full credit to $6,000 of earned income.

For a family with three children, the full credit to $7,000 of earned income and,

For a family with four or more children, the full credit to $8,000 of earned income.

Phase-out all credits at $12,000 (above the poverty level of a family of four). I would prefer an alternative that accepted the "notch" effect with no phase-out as argued earlier in my paper, but I would rather accept a rapid phase-out than be "side-tracked" into an argument over the "notch" and its effect on the work incentive which would delay agreement on an improvement in the E.I.T.C.

Raise the dependent exemption for families subject to the income tax.

I presume that financing for the E.I.T.C. portion of this proposal could be effected in an overall tax package through adjustments in the amount of the increase in the personal exemption or by limiting the increase in the exemption to dependents only. In any event, the cost of improving the E.I.T.C. can be reduced significantly by accepting my thesis that at these levels of income the disincentive effects of a "notch" are offset by other factors and the incentive for working people to achieve career success. This thesis has been validated by numerous studies of the effects on the working poor of the 1981 Reagan Welfare reforms as reported by Nicholas Lemann in the September 1984 issue of the Atlantic. (pp. 38–40.)

CONCLUSION

The working poor with children again need tax relief as was urged by then Governor Reagan and adopted by the Congress in the early and mid 1970's. Since that time inflation and increases in the payroll tax have eroded those benefits.

By increasing and indexing the E.I.T.C. to match the combined employee-employer payroll tax rate and increasing and indexing the income levels to which the credit can be applied on the basis of the number of children in the family, we can maintain the integrity of the E.I.T.C. as a form of tax relief and recognize that need for tax relief increases with increases in family size. Benefits from the credit will be earned benefits, since families will be refunded the payroll tax paid by them or on their behalf as a result of their work.

Increasing and indexing the dependent exemption and the level of income at which the income tax is levied will provide needed relief from the income tax for the working poor and near poor.

Precise levels of income to be affected by these recommended changes can be determined within the context of the various tax simplification proposals pending before the Congress and the Administration, but tax relief for low income families should have a high priority.

Thank you Madam Chairman for permitting me to present my views to your Committee.

Mrs. SCHROEDER. Mr. Minarik, we welcome you. Thank you very much for being here.

STATEMENT OF JOSEPH J. MINARIK, SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE

Mr. MINARIK. Thank you.

At staff request, I wrote a statement that attempts to cover two topics. First, is an outline, an explanation of how the Federal income tax system works, including in particular its aspects that impact families; second, a highlight of the policy issues with respect to those family aspects of the system. I do that with an eye on the notion that systematic tax reform seems to be an item of public discussion So, we may be able to look at some blue-sky kinds of options that we wouldn't consider in a more narrow context.

I put at the end of my statement a kind of a schematic drawing, if you will, of the outline of the Federal tax system. There should be two of them at the end of the statement, so you can tear one off and use it to follow as the statement proceeds. I will not be reading the statement, however.

To start from the top of the drawing, we have one basic premise of income tax theory. That is that the best tax system would tax all income. That is true for two reasons.

First, if you tax all of income, the system is more fair, because that means that there are no people who are singled out to be able to remove their income from taxes and therefore have advantages over their neighbors.

The second is that, if we tax all of the income, the rates that we apply can be as low as possible. The lower the tax rates, the lesser the incentive to avoidance and evasion and the greater the incentive for productive activity.

I call that top oval on the figure true income, but it is highly unlikely that any group of policymakers or tax experts would come to any agreement over what true income really is. What we have instead is an aggregate of income to which we apply our income tax system. That is what we call adjusted gross income, which is a little bit further down the figure.

Obviously, to get from true income to adjusted gross income, we leave some things out. Now, if we don't know what true income is, we don't know everything that we leave out. But we do know some things that we leave out. We have certain specific statutory exclusions and also exclusions that are provided in some cases by regulation.

I would like to suggest, as I do in my written testimony, that there are a number of exclusions that we apply to the tax system that are intended to do things that we consider to be worthwhile. But I would suggest that, from the point of view of most tax experts, those exclusions tend to boomerang.

I have two examples in the statement that might be related by some people to the issue of the family. One is employer-provided fringe benefits, and the other is the interest on whole life insurance policy reserves.

Some people would argue that by excluding fringe benefits from the tax system we help out working people who receive those benefits for the protection of their families. We hear a lot from organized groups who receive those fringe benefits. We don't hear very much from the other roughly one-third to one-half of all working people who don't get those fringe benefits.

In a world, as ours is, in which we are constrained for revenue, if we give a tax break to families that get fringe benefits, we are necessarily taking out of the pockets of the others who don't. Just as a very simple example, consider two wage earners, both of whom receive the same cash wages, one of whom receives very generous life insurance, health insurance, legal insurance, dental insurance, child care, and so forth, and the other of whom does not. Under the current tax system, they pay the same tax. I think that if we look at that from an objective point of view, you would have to consider that the person who is not receiving those fringe benefits is getting a raw deal.

The same thing is true of people who buy whole life insurance policies and receive tax exempt interest on the reserves that those policies build up. Ostensibly, life insurance is for the protection of families. You can buy life insurance in two different forms, whole life insurance and term life insurance. Those who buy term life insurance are footing part of the bill for those who buy whole life insurance and get the tax break. And it is very obvious that in the last few years the insurance industry has been selling whole life insurance largely on the basis of its tax advantages.

So, if we want to be fair to families, we should probably tax all of income and use other features of the tax system—and this is particularly true if we are looking at a wholesale reform of the tax system—to help families. We can use the personal exemption. We can use the standard deduction. We can use the rate brackets to provide tax relief for working families. But let's tax working families in different situations on a fair basis.

Now, what's left after we take those exclusions out of what I call true income is what we now call adjusted gross income. And that's the top line for computing income taxes.

Next, we attempt to make some reductions in this total or adjusted gross income before we apply tax rates to it. The reason we do that is, if we did not take something out of adjusted gross income, we would be taxing the poorest of the poor. We would be applying taxes to their very first dollars of income.

Now, ever since the income tax was introduced in 1913, we have had exemptions of one sort or another. Those exemptions are somehow tied into the notion of a cost of living, exempting some amount of income that people need in order to keep themselves going. We only tax the excess over that.

There are some details in the exemptions for taxpayers and dependents. There are details in terms of who is a dependent. We have extra exemptions for the elderly and the blind. I go into those in the written statement. I don't think they require too much mention here.

There are some policy issues with respect to the personal exemption. One is, as you heard from several witnesses so far, the exemptions have been eroded substantially by inflation. We might want to mention right now that the 1981 tax cut, which cut tax rates across the board and therefore was alleged to be neutral by income group, by not indexing the personal exemption and the standard deductions in the first instance, in fact imposed real tax increases on low-income people while upper-income people received substantial reductions.

Then there is another issue. We may agree that the personal exemption has been eroded and that we have to do something about that in order to provide relief for families and, for that matter, for single people. But there is a question as to how we provide that relief. We should keep in mind that under a graduated tax rate system, increasing personal exemptions allows the greatest dollar savings to people in upper tax rate brackets. In part for this reason, increasing the personal exemption costs an awful lot of money.

If we want to put tax relief where we might say it is needed, at the families below the poverty line who are now paying taxes, in-

creasing the personal exemption is a fairly expensive way to do it. There are other ways to go about it. I will discuss at least one a little bit later on.

In addition to reducing adjusted gross income with personal exemptions, we also take out deductions. Now, going all the way back to 1913, there were provisions in the income tax law that said that certain types of income should not be subject to tax, or certain expenditures should be deductible from income subject to tax. In some cases this was in order to define income more accurately. If someone was in the business of buying and selling goods, he wanted to get a deduction for the cost of goods sold. That is obviously a cost of earning income.

We had a deduction for medical expenses because we are of the opinion that that is a hardship item, and it should not be subject to tax. So, people should get tax relief for medical expenses.

We had a tax deduction for charitable contributions because we think that giving to charity is a good thing to do, and we want to encourage people to do that.

So, generally, we have deductions in order to define income, in order to provide relief from hardship, or in order to provide incentives for activities we think are wholesome.

However, when we went from the 1913 income tax, where about 1 percent of the population paid tax, to the post-World War II income tax, where three-quarters of the population paid income tax, we went from a situation where those people who paid tax were capable of a lot of the paperwork and recordkeeping that is involved in itemized deductions, to a situation where there were a lot of people for whom this was an inordinate burden. So we introduced a standard deduction, and people could claim some dollar amount in lieu of going through all the paperwork and record keeping of itemizing their deductions.

Now, one of the most important developments of the 1964 Kennedy-Johnson tax cuts was to introduce something called a minimum standard deduction. At that point the standard deduction took on a second aspect. Not only was it a relief from recordkeeping obligations, but it was also a relief for low-income people. There was a greater amount of standard deduction available to low-income people, and that provided a tax reduction for people who were around the borderline of the poverty area.

It is worth keeping in mind that the way the standard deduction was formulated in 1964 was at least in part keyed to exempting people with poverty level incomes from taxation.

We now call the standard deduction the zero bracket amount. That is a technical change. There really isn't any substantive difference there. I go into that in the written statement.

I think it is important to keep in mind that over the last decade not only has the personal exemption been eroded by inflation but the zero bracket amount, or standard deduction, has been eroded by inflation as well, and to just about the same degree. So, if we want to provide relief to low- and moderate-income people, one thing we should keep in mind is putting some of that relief into the standard deduction and not only into the personal exemption.

There are a couple of reasons for that. One is, when the standard deduction goes up, a lot of low- and moderate-income people are

saved the burden of itemizing. A decade ago, about 30 percent of the American people were itemizing their deductions; now it's about 37 percent. So, in current numbers that is about another 7 million itemized deduction tax returns, which is a big burden for the IRS and not only for the people who have to wipe the sand out of their eyes on the evening of April 15.

The other thing is that the standard deduction is claimed, for the most part, by people with low and moderate incomes. So, if we lose revenue by increasing the standard deduction—that revenue loss is going more where it is needed—to protect poor and marginally poor families from the tax burden.

I had a discussion in the written testimony about how the standard deduction contributes to some degree to the marriage penalty. We could go on on that for quite some time. Just let me say here that the marriage penalty with respect to all these questions is a very, very knotty issue. It is one that we have to think about very carefully in making any of these changes.

Moving on very quickly down the table—when we get done with our exemptions and our itemized deductions—we have taxable income. We apply our tax rates to that, and we come up with something that we call tax before credit. Now, there are a number of important policy-related issues that affect tax rates with respect to families. We have different tax schedules for single people, for married couples, and for what we call heads of household, who include, for the most part, single-parent families.

How we distinguish among those tax rate schedules is a very important issue. Again, it gets into the marriage penalty. Again, that is a topic that is very, very complicated.

Now, we do allow tax credits. Tax credits are often put into place as an alternative to itemized deductions, in part because of the question I raised earlier, that a deduction is worth more to an upper bracket taxpayer than it is to a lower bracket taxpayer. In addition, it is very easy to give a tax credit to all taxpayers. If you introduce an itemized deduction, it only goes to people who choose to itemize, although you can give a deduction above the line, in effect, a deduction from adjusted gross income. And we have about a half dozen of them in our current tax system.

There are two tax credits that are highly relevant to families. One of them is the child care credit; it is called the child and dependent care credit, technically, because it can be claimed not only for a child but also for a parent or any other dependent who is in need of constant care.

The child care credit right now is available at varying rates according to the amount of income that the taxpayer receives. It can be as much as 30 percent, and it is phased down to 20 percent at about $28,000 of income. That is, in fact, a very complicated structure, given what we want to achieve. If we consider child care as a cost of earning income, it should be something that is deducted from income. Therefore, the complication of the credit and the graduation of the rates of the credit really have to be justified on other grounds.

Then we have the earned income tax credit, which was mentioned before. Again, the earned income credit was not indexed

over the last few years. Compared to when it was introduced in 1975, it is available at much lower amounts.

I think it is important to keep in mind that the earned income credit does have some limitations in terms of the support that it gives to families. For one thing, very often the earned income tax credit comes in a lump sum, after the tax year is over. It is very complicated for an employer to work out the reduction of withholding so that it is divided over the entire year. And a lump sum, sort of a Christmas club, is not necessarily the best kind of support for a family that needs it on a day-to-day basis.

Another problem with the earned income tax credit is that, by all evidence that we can muster, it appears that a lot of people are not claiming it. People who have income so low that they do not have tax withheld sometimes don't file. And if you don't file, you don't get the earned income tax credit. So, that is an area where I think we have to provide some effort. But, again, the earned income tax credit is one of the few devices in the general government income support system that in fact helps out working families and particularly intact families, where husband and wife are together. So, it is an important element of the tax system and of the income support system on those grounds.

I am over my time, so I will stop.

[Prepared statement of Joseph Minarik follows:]

47-748 O—85——2

PREPARED STATEMENT OF JOSEPH J. MINARIK, SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE, WASHINGTON, DC

One of several frequent and important complaints about the federal income tax is that it is excessively complex--that most typical American families do not understand even the basic principles that determine their tax liabilities. At the Select Committee's request, this testimony is a primer on these basic tax provisions. It is my intention that readers of this testimony will understand at least the basic framework of the individual income tax law that applies to taxpaying families.

The basic outline of the testimony is captured in the attached figure. The figure illustrates the determination of a family's tax liability by showing the computations made in the course of calculating the federal income tax, and highlighting the tax law provisions that have a major impact on that calculation for families. The text of the testimony will follow this figure from top to bottom. It will be helpful to refer to the figure while proceeding through the text.

The tax computation itself can be divided into three parts. The first is the determination of the taxpayer's gross income; the second is the computation of taxable income; and the third is the calculation of tax due. To highlight the most important tax policy choices affecting families, however, each of these basic parts will be subdivided.

TRUE INCOME

The oval at the top of the figure is "true income." This is the sum total of all of the increases in the taxpayer's capacity to consume and save in the course of a year.

It is perhaps the most basic tenet of tax theory that we should tax all of income, with as few exceptions as possible. Taxing all of income is the fairest approach, because then no one can take advantage of his neighbors by having his own income exempted from tax. Taxing all of income is also the most efficient course, because the larger the tax base, the lower the statutory marginal tax rates, and thus the less the economic distortions and inducements to tax manipulation.

Unfortunately, "true income" is only a concept; it is not an operational measure. It is unlikely that many economists or policymakers could agree on what "true income" really is.

EXCLUSIONS

We have explicitly chosen in our tax law not to tax certain types of income. While there is no consensus on what true income is, there is no question that those identifiable types of income that are excluded from tax in the law should be included in true income.

These exclusions are allowed for different reasons; some make more sense than others. We do not tax welfare benefits,

for example, because this form of income is distributed according to means tests, and thus goes almost exclusively to people whose incomes are so low that they would owe no tax anyway. To tax welfare benefits, even though they are unquestionably income, would raise little revenue but would add substantially to the administrative burden of the income tax.

There is no such sound rationale for excluding some other types of income, such as interest on whole life insurance policies or employer-paid fringe benefits. Some people argue that taxing the interest buildup on whole life policies would penalize workers who are trying to protect their families, but excluding such income penalizes workers who try to protect their families in other ways (such as buying term life insurance). If people who buy whole life insurance are allowed to pay less tax on their true income, and the government needs any given amount of money to finance its activities, then other taxpayers must pay more tax. Likewise, some argue that excluding employer-paid fringe benefits is giving a break to working people; but it is really putting an extra burden on workers who do not receive fringe benefits (not to mention the elderly who are no longer employed). Workers without fringe benefits have to pay the same tax as others with the same cash incomes and generous fringes as well.

In short, however desirable some tax exclusions seem, in the final analysis they are counterproductive. Every exclusion for some group of taxpayers is a penalty for all others. If comprehensive reform of the tax law is a live option, then

general provisions of the tax law (including the tax rates) can be changed to give compensating tax relief to low- or middle-income taxpayers, preventing any unfavorable net impact.

ADJUSTED GROSS INCOME

Adjusted gross income (AGI for short) is the income measure that we use for tax purposes; it is ostensibly the sum of all income, excluding those types of income specifically excluded by law or regulation. AGI is thus the "top line" for purposes of computing income taxes. Because few people other than tax theorists tend to think about a broader concept of income as being more desirable, AGI is the global measure of income for most people.

PERSONAL EXEMPTIONS

The next broad step in computing tax liability is to compute taxable income from adjusted gross income. Because AGI is considered to be the sum and total of the increment to a family's resources in a given year, and because we do not want to tax all of a family's income if that income is very small or if that family has endured extraordinary expenses or hardship, we excuse a limited amount of income from tax. That is, we allow families to reduce their adjusted gross income before they arrive at taxable income, the amount of income on which they actually pay tax.

We allow two kinds of reductions from AGI. The first is,

in general, an equal and fixed reduction of AGI for each person in the family. This reduction is called the personal exemption. (The second reduction is called either a standard deduction or itemized deductions, and is described in the next section.)

The reasoning behind the personal exemption is that it takes a certain amount of money to meet the basic needs of life for every person. Under the current law, the amount of the personal exemption is $1000, indexed for inflation over a base period of fiscal year 1983. With this indexation, the personal exemption for 1985 will be $1040. Prior to 1985, the personal exemption had been $1000 since 1979. Because inflation had increased prices by over 40 percent between 1979 and 1984, however, the real value of this constant $1000 exemption deteriorated substantially over time. (But even this account understates the erosion of the personal exemption over time. From 1976 to 1978, the tax law allowed a $750 exemption plus a $35 credit against tax due for every person in the tax unit. The $35 credit was the equivalent of an extra $250 exemption for low-income taxpayers, yielding the equivalent of a $1000 exemption as early as 1976, and making the period of effective constancy for the exemption even longer.)

When the Congress passed the very large tax cuts of 1981, it ignored this erosion of the personal exemptions, distributing most of the revenue cut through reduced tax rates. This choice worked very much to the disadvantage of low- and moderate-income families and individuals. For those whose incomes are low, a complete exemption of a small amount of income would have

reduced tax more than the rate cuts in the 1981 law. In this sense, low- and moderate-income families and individuals were losers in the 1981 tax cut. I attach testimony I presented last year to the House Ways and Means Subcommittee on Oversight, which documents the effect of this erosion of the personal exemptions on taxpayers with poverty-level incomes.

There are some important technical details of the personal exemption. The person filing the tax return (and his or her spouse, if any) may claim exemptions for any dependents. In some cases, the dependent concept is very simple, as in the case of a young child dependent upon his parents. Nonetheless, there are cases where a fine line must be drawn. A child remains a dependent only so long as his parent(s) supplies at least half of the child's support. Children 19 or over, except full-time students, also must have incomes under a set amount to qualify as dependents. Persons who are not children of the taxfiler or spouse must either be related in some way or have lived in the taxfilers' house for the entire year, as well as meet the 50 percent of support and the maximum income tests, to be claimed as dependents.

The taxfiler and spouse may claim an extra personal exemption if he or she is 65 years of age or older, and if he or she is blind. Thus, a blind 65-year-old filing his or her own tax return can claim three exemptions. (The extra exemption is not available for blind children or other dependents of the taxfiler and spouse, or for an elderly dependent parent who does not file his or her own return.)

STANDARD OR ITEMIZED DEDUCTIONS

In addition to the personal exemptions, the law allows taxpayers to reduce their taxable incomes through deductions. These deductions come in one of two kinds. Itemized deductions are allowed to compensate taxpayers for particular kinds of expenses that vary from taxpayer to taxpayer and are thought to be particularly burdensome or to contribute to meritorious activity. Thus, medical expenses, which are thought to be an unrewarding and sometimes an excessive burden, are deductible to the extent that they exceed 5 percent of income. State and local taxes are deductible, in part to prevent the federal income tax from being "a tax on a tax." Charitable contributions were made deductible in part to encourage such altruism.

The computation of many such deductions is tedious, and it can be difficult, especially when many different rules distinguishing proper from improper deductions are involved. To relieve some taxpayers of this compliance burden, a standard deduction was introduced as an alternative to itemized deductions. In the 1950s and the early 1960s, the standard deduction was 10 percent of AGI; if itemizable deductions were less than that amount, or if the taxpayer preferred not to itemize his deductions, he could claim the standard deduction instead.

An important part of the Kennedy-Johnson tax cuts of 1964 was the introduction of a minimum standard deduction, a dollar

amount that was partly based on family size (initially, $200 plus $100 for each taxfiler and dependent). This raised the standard deduction for low-income individuals and families (they could claim the dollar amount if it exceeded 10 percent of their incomes) and saved more of them from the burden of itemizing. Over time, however, the role of the standard deduction in reducing taxes for low-income persons became more prominent. Further, the standard deduction itself was simplified. The formula based on family size was cut back in stages to fixed dollar amounts that vary according to the type of household (primarily differentiating married couples from single persons).

By the late 1960s, tax policy became conscious of the official definition of poverty. Many policymakers determined that families should be allowed to earn an amount of income at least equal to the official poverty standard without paying tax. The means of achieving this goal was to make the standard deduction and the personal exemption combine to equal the poverty standard. Over time, this goal has been achieved by increasing both personal exemptions and the standard deduction.

In recent years, however, the standard deduction (recently called the zero bracket amount in a move that did not change the basic concept) has fallen behind inflation in much the same way as the personal exemption. As early as 1977, the zero bracket amount for a married couple was $3200, and that for a single person was $2200. In 1985, these have increased to only about $3500 and $2400 respectively. Needless to say, given intervening inflation of about 50 percent, this represents a

substantial erosion. Again, my testimony of last year documents the effect on low-income persons and families.

The amount of tax-free income available to families can be increased by increasing either the personal exemption or the zero bracket amount, or both. These two instruments have the same general effect, but there are some important distinctions. The personal exemption applies to every person in a family, but the family as a unit gets only one zero bracket amount. Thus, increasing the personal exemption is relatively more generous to large families, and less generous to small families, than is increasing the zero bracket amount. Increasing the exemption has no simplifying effect of reducing the number of itemized tax returns, while increasing the zero bracket amount does simplify in this way. Finally, because every person regardless of income can claim a personal exemption, and because the value of the exemption is greater for taxpayers in higher marginal tax rate brackets, increasing the exemption is relatively generous to the wealthy. In contrast, because most upper-income taxpayers itemize their deductions, increasing the zero bracket amount gives a tax cut mostly to lower-income taxpayers. All of these considerations are relevant in the choice of a personal exemption and a zero bracket amount in the context of the current tax law, and in tax reform.

Under the current law, but only through 1986, taxpayers who claim the standard deduction can also claim an additional deduction for charitable contributions. This deduction is intended as an incentive. It has the unfortunate side-effect of

complicating the tax-filing process for those for whom the zero bracket amount was intended to be a simplification; it also duplicates the intended benefit of the zero bracket amount. For these reasons, plus the generally low tax benefit of this deduction to those who claim it, the merits of the deduction seem limited.

While most tax returns do not have itemized deductions, many of those who do not itemize are young single people who do not yet own homes (and thus have no mortgage interest to deduct) or elderly people who have largely paid off their homes (for the same reason). While there are no definitive data, families are probably about as likely as not to itemize. So on the one hand, we might look at itemized deductions as tax relief for families; on the other, at least for those with moderate incomes, itemized deductions are probably what make family taxfilers tear their hair out on the early evening of April 15. Increasing the zero bracket amount (or repealing some itemized deductions with compensating tax cuts in some form) would leave families at least as well off financially and much better off when the time comes to compute their taxes.

One tax policy issue with respect to the zero bracket amount is the treatment of one-parent families. Under the current law, married couples may claim the larger zero bracket amount of just over $3500; both single people and single parents of families are restricted to the smaller ZBA of about $2400. Some people have argued that single parents have the same kinds of family responsibilities (in some ways, even greater ones) as

married couples, and thus deserve the bigger ZBA. We do now allow single parents some concessions on their tax rates; the issue is whether those concessions are enough, or if additional relief through a larger ZBA is justified.

This raises yet another tax issue for families, the so-called marriage penalty. When two working people marry, chances are that their income tax as a married couple will exceed their combined taxes as single persons. (On the other side of the coin, if one of the spouses does not work, their tax as a married couple will be lower.) This is caused by several features in the tax law, including having a ZBA for married couples that is less than twice the ZBA for single persons. (Each single person can earn about $2400, the single ZBA, without paying tax; when they marry, they can earn between them only about $3500, the couple ZBA, without tax.) The marriage penalty imposes many costs on the tax system and society, reducing taxpayer morale and in some cases encouraging sham divorces. One reason for resistance to the idea of a larger ZBA for single-parent families is that it would increase the marriage penalty, by making the combined potential ZBAs of two spouses as single persons even greater relative to their ZBA as a married couple.

TAXABLE INCOME

Taxable income is what is left over after the taxpayer subtracts his personal exemptions and itemized deductions from his adjusted gross income. Taxable income is the amount on

which the taxpayer actually pays tax.

There has been a change in terminology in the last decade that can be confusing. Prior to 1977, taxable income was the remainder of adjusted gross income less personal exemptions and either the standard deduction or total itemized deductions. This was changed in 1977, when the name of the standard deduction was changed to the "zero bracket amount," in an attempt to simplify the mathematical computations for the taxpayer. Now taxable income is equal to AGI less only the personal exemptions, in the case of the nonitemizer. For those who itemize their deductions, taxable income is equal to AGI less their personal exemptions and the excess of their itemized deductions over the zero bracket amount (which used to be called the standard deduction). Thus, compared to the pre-1977 terminology, everyone's taxable income, whether he itemizes or not, is greater by the amount of his standard deduction (zero bracket amount). In exact compensation, however, the tax rate schedule now has built into it a bottom bracket with a zero tax rate which applies to an amount of income equal to the old standard deduction (hence the term, "zero bracket amount"). This is done to save the taxpayer one mathematical computation; he or she need not subtract the zero bracket amount from AGI in arriving at taxable income. The amount of tax due is exactly the same, whether we use a standard deduction or a zero bracket amount.

TAX RATES AND TAX BEFORE CREDITS

The first measure of tax liability, called "tax before credits," is computed by multiplying taxable income by a set of tax rates. There are different tax rate schedules for married couples, single persons, and heads of households (this last group including single parents of families). (There is another rate schedule, seldom used, for married persons filing separate tax returns.)

The relationship among these rate schedules in mathematical terms is quite complicated. Oversimplifying a bit, the tax rate schedule for single people is somewhat like that for married couples, but with the tax rate bracket boundaries cut roughly in half, and with some of the tax rates reduced a little. The slightly lower rates are a concession to single people who complained that their taxes were too high compared to married couples with the same total income. At the same time, of course, cutting tax rates for single people annoys married couples who lose those lower rates when they marry; that is part of the marriage penalty.

Oversimplifying again, the tax rate schedule for heads of households (including single parents of families) is like a compromise between the rate schedules for married couples and single people, with tax rate bracket boundaries a little lower than the former and a little higher than the latter. Again, this concession to single-parent families, as deserved as it may be, causes problems by exacerbating the marriage penalty

problem. It should be clear from this discussion of rate schedules and standard deductions that the disputes between married couples and single persons over taxes has no simple and complete solution.

One rampant misconception about tax rates is the fear that a small amount of extra income will "put me in a higher tax bracket" and therefore cause a dramatic increase in taxes. Some people think, for example, that moving from a bracket with a 22 percent rate to the next with a 25 percent rate will increase their taxes from 22 percent of all of their income to 25 percent of all of their income, a very big jump. This, of course, is not the case. Only the last few dollars of such a taxpayer's income would be taxed at 25 percent; the other dollars would be taxed at the lower rates. So the one dollar of income that carries the taxpayer from the 22 percent bracket to the 25 percent bracket would not increase his taxes by several hundreds of dollars, but rather by 25 cents. The popular minconception on this score is probably caused by the "lookup tables" in the tax instruction booklet, where (using the 1984 booklet for illustration) increasing a married couple's taxable income from $10,499 to $10,500 would increase its taxes from $886 to $893. This result arises only because the lookup tables are somewhat simplified to keep them to a reasonable length. Larger increases of income, such as from a pay raise or taking an extra job, would have no such effect. Although this misconception is baseless, there is no telling how much mischief it causes.

TAX CREDITS

The taxpayer is not finished with his work even after he has consulted the tax tables; he must still compute his tax credits. Tax credits directly reduce the tax due; thus, a $1 tax credit reduces tax liability by $1. This is in contrast to a $1 tax deduction or exclusion, which reduces tax by 50 cents for a taxpayer in the highest tax rate bracket, 11 cents for someone in the lowest tax bracket, and intermediate amounts for those in between. Some people argue that tax credits are fairer than deductions or exclusions because they are worth the same to high- and low-income persons; this argument has some validity in some cases, but it would not apply to deductions for expenses that are costs of earning income (such as costs of goods sold, for example). Those expenses should be deducted and should apply at the taxpayer's highest rate bracket.

There are two tax credits that apply most directly to families. The first is the credit for child and dependent care expenses. Married couples with children, single parents, and persons with other dependents (such as elderly parents) who need supervision may claim a credit for the costs of providing care while the taxpayer works. The amount of expense on which the credit is computed is subject to a maximum amount; the current ceiling is $2400 for one dependent and $4800 for more than one. While some might argue that these ceilings are too low for some taxpayer circumstances, there is no question that some ceiling is needed. Without a ceiling, wealthy taxpayers could use the tax credit for (literally) Rolls Royce-quality child care. The

purpose of the credit is to make quality child care available; if a taxpayer chooses to buy luxury child care, he or she should do so at private, not public, expense.

The basic rationale for the child-care credit is that child care is a necessary cost of earning income for some working people. This would suggest that the taxpayer should not have to pay tax on the money he or she uses to pay for the child care; that is, the cost should be deductible. Instead, the current tax law allows a credit for child care expenses. In fact, the credit is quite complex; for lower-income working people, the credit is as large as 30 percent of the child care expenses, but the credit is phased down to 20 percent as AGI approaches $28,000. The higher credit for low-income persons is more a positive inducement to work than a simple compensation for necessary expenses; and the complexity of the computation is hard to justify.

The child and dependent care credit is nonrefundable; that is, if the credit exceeds the tax otherwise due, the tax is reduced to zero, but the unused remainder of the credit has no effect.

The second credit specifically applicable to families is the earned income tax credit. This credit was formulated to reward low-income working heads of families, and to compensate them for the Social Security payroll tax. The earned income credit applies only to families with children; unlike the dependent care credit, elderly parents or other dependents do

not qualify. The earned income credit was introduced in 1975. Under the current law, the credit equals 11 percent of earned income, with a maximum credit of $550. The credit remains at $550 as income increases from $5000 to $6500; the credit then phases down to zero as income increases to $11,000. Unlike most other credits, the earned income credit is refundable; if the credit exceeds tax otherwise due, the excess is paid to the family in cash. This credit is not the most graceful income support policy; because it is paid to the family in a lump sum after the year is over (unless the employer undertakes some fairly complex paperwork), the help does not really get to the family when it is needed. Nonetheless, the earned income credit is one of a very few tax or transfer programs that provides assistance to low-income working families.

Unlike the exemptions and zero brackets, the earned income credit is not indexed for inflation. That fact, plus a very substantial erosion of the credit by inflation since it was enacted, means that the credit is less effective than it once was and will erode further unless action is taken. The Treasury Department's tax reform proposal of November, 1984 would index the earned income credit.

TAX AFTER CREDITS

. With the subtraction of the tax credits, most taxpayers' final liabilities are computed. Further computations are necessary for those who owe minimum taxes because of their use of tax preferences. When these minimum taxes are added to tax after credits, the sum is called "total income tax."

Parental Expenditures on Children

I would like to conclude with a brief description of the work of my colleague, Thomas J. Espenshade, estimating parental expenditures in raising children. This work is described in his book, Investing in Children: New Estimates of Parental Expenditures (The Urban Institute Press, 1984).

Espenshade's objective is to estimate not the essential costs of raising children--the necessary expenditures for keeping body and soul together--but rather what parents actually spend. He controls for some of the most important determinants of those expenditures: the socio-economic status of the parents, the number of children, the spacing of the children's births, and so on. For a family of medium socio-economic status, with two children and a working wife, the average total expenditure to raise a child through age 18 is $82,400 in 1981 dollars--an average of not quite $4600 per year.

Another aspect of Espenshade's work is an attempt to measure the "economies of scale" in raising children--the degree to which raising one child tends to reduce the cost of raising another. Espenshade finds that these economies are small--perhaps 5 or 10 percent. This is not surprising if we consider that many of the major expenses of child-rearing, such as school tuitions and medical bills, are not generally subject to economies of scale.

I believe that Espenshade's work is extremely useful in considering the tax treatment of the family. I would caution, however, that this work is more useful in suggesting the proper direction of change--towards more tax relief--than it is in indicating a precise magnitude of change. I also would not read into Espenshade's results a conclusion that we must increase the personal exemption to some fixed amount, rather than providing relief through some other policy tool.

Again, for example, Espenshade is careful to point out that he has estimated actual expenditures, not necessary expenditures. There is no reason why tax policy should

exempt an amount of income equal to typical middle-income expenditures on children, any more than the exemption should match low- or high-income expenditures.

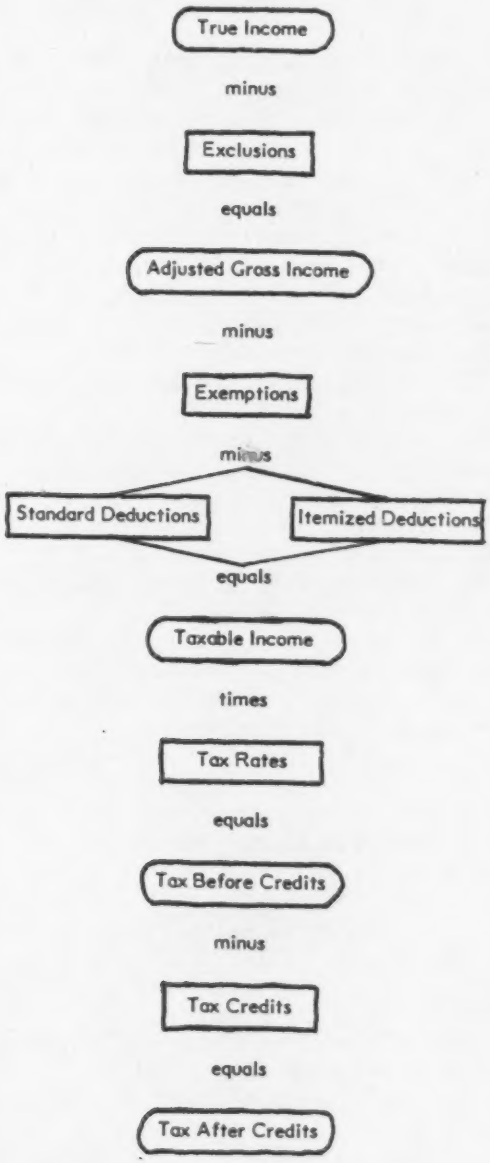
Further, tax policy is constrained by what we can afford. If we had allowed a $4500 exemption for children in 1982 instead of the actual $1000 exemption, taxable income would have been reduced by $250 billion--about one-sixth. The revenue loss would have been about $50 billion. Obviously, such a cost would have had to have been borne by reductions in other programs or increases in taxes--steps that would require the most careful consideration of priorities.

Finally, as was noted above, the personal exemption in the current tax law reduces liabilities to the greatest extent for upper-income taxpayers. If our concern is to direct help in meeting child-rearing costs where it is most needed, a simple increase in the exemption is not necessarily the best method.

Espenshade's research does highlight, however, the degree to which both personal exemptions and zero bracket amounts have been left behind by the cost of living. Some attention to these tax provisions is called for.

Joseph J Minarik
The Urban Institute

STRUCTURE OF THE FEDERAL INCOME TAX



Mrs. SHROEDER. Thank you very much. That was very, very informative information.

Mr. Schorr, we are very happy to have you with us and look forward to what you have to say.

STATEMENT OF ALVIN SCHORR, LEONARD W. MAYO PROFESSOR, CASE WESTERN RESERVE UNIVERSITY

Mr. SCHORR. Congresswoman Schroeder and Congressman Evans, I am Alvin Schorr. I am Leonard Mayo Professor at Case Western Reserve University.

I can be brief. I have, you will be delighted to know, at least one answer to the question that you put to Senator Moynihan.

First, I want to make two general points. One is that Senator Moynihan pointed out that poor families are in trouble in the United States. He mentioned the figure that 50 percent of children now under 18 will suffer a period in a single-parent family, a situation closely connected with poverty. I mention in passing that NIH has just within the past 3 or 4 weeks redone those estimates. They come up with 70 percent. That's their figure, 70 percent of children now under 18 will spend a period of time in a single-parent family.

Mrs. SCHROEDER. Seventy percent.

Mr. SCHORR. That's right. If 50 percent has so far failed to shake us up, I guess 70 percent will.

I want to add to that concern about poor families, concern about families with marginal and middle incomes. As far as I know, the last Government survey of family expenditures was done 10 or 12 years ago. At that time a middle-income family, an income equivalent to about $24,000 now, typically a family with two parents, a man about 35 years old and two children, was spending about $200 more than their total income each year.

That was 1972-73—a prosperous period. Matters are obviously now worse for middle-income families for a variety of reasons. So, there is enormous pressure on middle-income families and, of course, more pressure on poor families.

The second general point that I want to make is that our social insurance system, Social Security and unemployment insurance, is poorly adapted to this problem of helping with the income of families with children. The reasons are inherent in the concept of social insurance. This is not a criticism of the system; it does what it does, in my view, very well, but it does not do everything. It can only provide benefits in some relationship to prior earnings. Except within very narrow limits, survivors insurance, disability insurance, and unemployment insurance cannot and do not provide for family dependents—chiefly children. And of course the social insurances do not meet the needs of the socially orphaned, children of divorce, separation, or no marriage, at all.

Another problem for families with children is that family need is out of synchronization with family income. In general, family income is lowest when a family is young and family need is highest—for a variety of reasons. The salary hasn't advanced; it's harder for a mother to work; later on she can work and earn more, and so forth. By the time families reach maximum earnings, their children are launched. That accounts for a phenomenon we are all

familiar with, that 50-year-olds seem to experience a measure of relief from financial stress.

They did once; right now, I am not sure about.

So, there is an inherent problem in social insurance, and in the fit of family income to family need. There ought to be some way of addressing these problems.

Now, to get to tax law, everybody understands one general problem. In the last few years poor families in particular and other families as well, with less than average or average incomes, have experienced a lot of trouble. Your figure of $2,600 as the current value of the $1,000 personal exemption if it were updated, and Senator Moynihan's of $5,600 are well understood. The personal exemption has not progressed in accordance with the cost of living.

Because everybody understands that, most proposals for tax simplification in one way or another address the issue of protecting low-income families. The administration's first-round proposal would have doubled the personal exemption. Congressman Kemp's proposal also would double the personal exemption.

If I may say so—and I guess I may—raising the exemption is a peculiar way to protect the interests of lower income people. It is a matter of simple arithmetic that an increase of $1,000 in an exemption is worth $350 to a family at a marginal tax rate of 35 percent. At the average marginal tax rate in the administration's first proposal, something like 19 percent, a family would gain only $190. And to a family at a lower rate of taxation or paying no taxes at all, it's worth nothing.

Now, we are talking about a lot of money. The revenue cost to the Government of the current personal exemption, is about $40 billion—$40 billion. The Treasury Department has not published a separate estimate of the cost of doubling the personal exemption. However, I venture to suggest that the cost of doubling the personal exemption is upwards of $30 billion.

So, what Congress will do in this matter is consequential. It seems to me to present an opportunity for departure for children that, if not taken now, will wait for a very long time.

Now, much more functional for families would be a so-called refundable tax credit—substituting a refundable tax credit for the personal exemption. That is analogous, Mrs. Schroeder, to your notion that people who don't use their personal exemption ought to be able to sell it—like corporations. It is, in effect, a similar concept.

A $350 or $200 tax credit, or whatever is specified, is worth $350 or $200 to every taxpayer. That doesn't provide favorable treatment to people with less income. It provides them parity, in contrast with the personal exemption, which provides favorable treatment to the higher and highest income people.

If made refundable, it is worth $350 or $200 to a family with so little income that they do not owe taxes. Current tax law, as you have now heard, contains the earned income tax credit—a precedent, in principle, for the refundable tax credit. The EIC is very modest, however. Even proposals to improve it wind up very modest. It is available only to those with earned income and at present only to those with up to $10,000.

I observe in passing, that the earned income credit (or improving the earned income credit) has this peculiar quality of trading off $30 billion in an improved personal exemption for upper income classes and compensating poorer families with a special second track. It incorporates two tracks into tax law: the personal exemption, which is of some consequence to upper income families, and the EIC, which can be of some consequence to lower income families but prices out at no more than $2 or $3 billion. Ten to one; maybe the poor ought to be satisfied with that; that's in the hands of Congress.

I can outline a feasible refundable tax credit for you in just a few words. Congress would eliminate the $1,000 exemption—this proposal was developed on the basis of 1984 tax law—and provide instead a $400 tax credit per person. A household's total credit would be reduced by 5 percent of income in excess of adjusted gross income of $10,000.

The existing earned income credit would be wiped out by this proposal. Special exemptions for age and blindness would be eliminated. (Even so, the average aged and blind person would be better off.) There would have to be other special provisions; I won't go into detail right now. People who do not owe taxes would be entitled to refunds as now. If the refund exceeds a stipulated figure, say $1,000, the Treasury could pay it out quarterly.

In these few minutes, I will also not try to go into detail about who would gain and who would lose. I submitted for the record an article published in the Journal of the Institute for Socio-Economic Studies last summer that provides a detailed breakdown. The analysis was done by Treasury and is as sound as such analysis usually is.

In general, couples and families, and families with children in particular would tend to benefit. As the median income of the aged is low, most of them would come out ahead. So too would those families, usually with relatively low incomes, with whom the so-called "hidden poor" aged live. These are mostly old women living with families. "Hidden poor" is Mollie Orshansky's term.

Sixty percent of the people who file a tax return would find the tax credit to their advantage. In addition, 5.5 million married couples and heads of households have incomes so low that they do not file returns. Obviously, they would find this credit to their advantage.

To conclude, if tax simplification is the objective, I observe that refund of a credit moves in a direction long urged by those who write, administer and litigate tax law. It would substitute a virtually self-defining entitlement to a credit for existing complex definitions of dependency and special tax favors.

Connecting with something that Mr. Minarik said, I want to say that one of the problems about applying for the earned income credit is that it itself is complex. Low income people have trouble with all these forms. A refundable tax credit is as simple as may be and would wipe out all these others.

Cost is an issue, it always is. The $400 refundable credit would cost the Government a little over $7 billion a year, compared with $30 billion or more for doubling the personal exemption. Taken all

alone that is not an inconsiderable reason that Congress should consider it.

There is an alternative to the proposal that I am offering you, an optional refundable tax credit. One would choose to retain the personal exemption or instead go for the refundable credit—an option under which no taxpayer would lose. I rejected that option because its cost is on the order of $30 billion. Yet it is no more than the cost of the administration's first-round proposal to double the personal exemption.

Now, the refundable credit would have other hardly negligible advantages. I estimate that it would reduce AFDC and SSI rolls by upwards of 25 percent, because it would provide a quarter of beneficiaries with equivalent or higher incomes than these means-tested programs. You might turn over in your heads the consequent reduction in hassle all around—for the Government and for the poor.

For poor families that do not receive assistance, in general it would provide half the deficit between their current income and poverty line income. It doesn't do the whole job that needs to be done but for the moment half the job is well worth doing.

For that typical middle income couple 35 years old with two children that I mentioned earlier, it would convert their $200 yearly deficit into a $300 gain. If I had some time, I would dwell on what small sums of money mean to such people in maneuverability and getting ahead.

I would like to leave you thinking about individual families and how they would be affected over time. It may be evident the younger families with children would have more income than under current tax law. Many families would, when earnings had approached a peak and children had left home, pay correspondingly higher taxes than now. They would, in effect, have loaned money to themselves in a straitened period out of their own prosperous futures. And the tax credit, the very loan to themselves, would have helped them in realizing that prosperous future.

I thank you for the opportunity to present these ideas.

[Prepared statement of Alvin L. Schorr follows:]

PREPARED STATEMENT OF ALVIN L. SCHORR, LEONARD W. MAYO PROFESSOR OF FAMILY AND CHILD WELFARE AT THE SCHOOL OF APPLIED SOCIAL SCIENCES, CASE WESTERN RESERVE UNIVERSITY, CLEVELAND, OH

Congresswoman Schroeder and members of the Committee, my name is Alvin L. Schorr. I am Leonard W. Mayo Professor of Family and Child Welfare at the School of Applied Social Sciences, Case Western Reserve University. Perhaps I should say that Leonard Mayo, now retired and living in Cleveland, spent over half a century working to protect and advance the interests of children, and it seems appropriate that I should testify for you with his titular and, I am sure, personal support.

Families with children have for a long time represented a large portion of the poor population, and their problem is growing. Even many middle-income families with children are experiencing difficulty. In the nature of the stages that they traverse, families tend to have least income when it is most needed and more income when it is needed less. When the government last conducted a survey of family expenditures, more than ten years ago, it found that an average two-child family with a 35-year old head was spending a couple of hundred dollars more than their total income each year. Those were relatively prosperous times; obviously conditions are now more difficult. Now, for reasons connected with the economy and government policy, young families are much more on edge, financially speaking; pressures are particularly acute and will be for some time at least.

Even small sums that can allow for manueverability and investment in advancement are important to young families. Yet our extensive and, despite all difficulties, fundamentally successful social insurance system, has been designed with an eye to individuals --- disabled, retired, unemployed, widowed and orphaned individuals, but not families. It therefore deals poorly with children as dependents and entirely misses many children, particularly those whose parents are unmarried or divorced or separated. Current debate about tax simplification presents the opportunity for a departure that could, in some considerable degree, ease the situation for families with children --- those with one parent and those with two, those who are poor and those with modest and even middle incomes.

Everyone seems to understand that many middle-class, not to say poor families have lost ground in the last few years, and so all proposals for tax simplification incorporate some provision for protecting them. The need to do that is reinforced by the fact, noted in Senator Moynihan's lecture at Harvard University a couple of weeks ago, that if the personal exemption had kept pace with inflation, it would now be $5,600 (instead of $1,090). The dependents for whom such an exemption is taken are, of course, mostly children. Various proposals seem to converge on the solution of sweetening the personal exemption. For example, the Administration's first-round proposal would have doubled the exemption from $1,000 (in 1984) to $2,000. However, raising the exemption is a peculiar way to protect the interests of lower-income people. It is a matter of simple arithmetic that an increase of $1,000 in an exemption is worth $350 to the family with a marginal tax rate of 35 percent, $200 to those with a marginal rate of 20 percent, and nothing at all to those with so little income that they are not liable for taxes.

I record for you that the revenue cost to the government of the current personal exemption is roughly $40 billion. The Treasury Department has not published a separate estimate of the cost of doubling the exemption, but I venture to suggest that it is in the range between $25 and $30 billion. What Congress will do in this matter is consequential. It can miss an opportunity for children --- possibly for a very long time --- or seize it.

Much more functional for families with children and, as it happens for aged women and for low income people in general as well, would be to substitute a so-called Refundable Tax Credit for the personal exemption. A $350 or $200 tax credit, or whatever is specified, is worth $350 or $200 to every taxpayer, regardless of income. If made refundable, it is worth the same $350 or $200 to a family with so little income that they do not owe taxes. Current tax law contains an Earned Income Credit --- a precedent in principle for the Refundable Tax Credit, but the EIC is very modest, is available only to those with earned income, and only up to $10,000 of earned income.

A feasible Refundable Tax Credit may be outlined in just a few words. Legislation would eliminate the $1,000 personal tax exemption (this proposal is based on 1984 tax law) and provide instead a $400 tax credit per person. A household's total credit would be reduced by 5 percent of income in excess of adjusted gross income (AGI) of $10,000. The existing Earned Income Credit would be absorbed by this provision, that is, would no longer exist as a separate credit. Special exemptions for age and blindness would be eliminated. Under current law, one may file an individual return and be claimed as a dependent on another return as well, if the conditions for dependency are met. Such duplicate filing would be barred. People who do not owe taxes would be entitled to refunds, as now. If the refund exceeds some stipulated figure, perhaps $1,000, it might be paid out in quarterly installments.

I will not try to go into detail now about who would gain and who would lose. I submit for the record a copy of an article in the Summer 1984 issue of the Journal of the Institute for Study of Socioeconomic Issues, that provides a detailed breakdown of costs and benefits of the proposal just outlined, and of alternative payment levels and other options as well. The analysis was prepared by the Treasury Department and is as authoritative as may be.

In general, couples and families, families with children in particular, would tend to benefit. Although the aged would forego their special exemption, as their median income is low most of them would come out ahead. Also benefiting would be those families, usually with relatively low incomes, with whom the so-called "hidden poor" aged live. Sixty percent of the people who file a tax return would find the tax credit to their advantage. In addition, 5.5 million married couples and heads of households have incomes so low that they have not filed returns; obviously they would find the refundable credit to their advantage.

To conclude --- if tax simplification is the objective, I observe that the RTC moves in a direction long urged by those who write, administer, and litigate tax law. It would substitute a virtually self-defining entitlement to a credit for existing complex definitions of dependency and special tax tables. If cost is the

issue, and when is it not?, the $400 RTC would cost the government a little over $7 billion a year --- compared with $25 to $30 billion for doubling the personal exemption.

Moreover, the RTC would have other, not inconsiderable advantages. By providing equivalent income without a means test, it would reduce AFDC and SSI roles by upwards of 25 percent. What a relief in the administration of these programs, not to mention the liberation for so many families from being hassled! As for poor families that do not qualify for AFDC and SSI, in general it would provide half the deficit between their current income and poverty-line income. That it does not do the whole job for them does not mean it is not well worth doing. For that typical middle-income couple with two children mentioned earlier, it would convert their $200 yearly deficit into a $300 gain.

I would like to leave you thinking about indidividual families and how they would be affected over time. It may be evident that younger families with children would have more income than under current tax law but many families would, when earnings had approached a peak and children had left home, pay correspondingly higher taxes than now. They would, in effect, have loaned money to themselves in a straitened period out of their own, more prosperous future. And the very loan to themselves would have helped in realizing that prosperous future.

I thank you for the opportunity to present these ideas to you.

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WOMEN AND CHILDREN LAST ---
BUT THEIR TIME HAS COME:
THE REFUNDABLE TAX CREDIT

Journal of the Institute
for Socioeconomic Studies

--- Alvin L. Schorr*

A considerable debate about tax law revision lies before us, though it may be conducted with more seriousness after the election than now. Projected budget deficits force a search for more revenue as well as for whatever savings in cost yet seem feasible. The outcome of the election will frame that debate, but it will in any case be influenced by two developments. First is the evidence that the Reagan years have seen a vast up-scale redistribution of income. An example is the estimate of an Urban Institute study that, despite economic difficulties since 1979, the richest one-fifth of American families are barely (a fraction of 1 percent) poorer, but the poorest one-fifth have suffered a decline in real income of almost 10 percent.[1] Also influencing the argument will be evidence that poverty has increased and, perhaps more powerfully, alarm over the number of families dropping from middle-income to marginal status --- 8 million families in the last five years.[2] That can in itself lead to grave economic, not to say social and political consequences.

In that context, whatever the tax increases that are visualized or thought necessary, it is likely that some care will be exercised

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I wish to express my debt to New York University Professor George Zeitlin who introduced me to the concept of the "vanishing" refundable tax credit many years ago. Law School Professors Deborah Schenk (NYU) and George Cooper (Columbia) were kind enough to comment on a draft of this paper.

to protect those who are least or less well-to-do. Special provisions favoring such people are likely to be traded off against revenue-producing provisions --- a uniform surtax, a flat tax with few deductions, a value-added tax, or whatever. More revenue will be sought in a manner that does not take money from the classes of people who have already suffered and that might, indeed, leave them relatively better off.

Thus, we have an opportunity that may not soon again arise to take a major, positive step in tax and transfer policy. General recognition that corrective or protective measures will be needed present the opportunity, not the reason for a departure. What follows will address the reason, that is, the circumstances of families with children, especially, and of aged women in order to make clear why it is their turn. There will be an explanation of the reasons for selecting a refundable tax credit from among the relevant transfer policies that western countries have used. Finally, a specific proposal will be offered.

Women and Children. Of all who are poor in the United States, 40 percent are children. The poverty rate for children declined to a low of 14 percent during the 1960s, and has since steadily gone up again to over 20 percent. In 1982, 13.5 million children lived in a poor family. Some experts believe that the government's fixed definition of poverty understates deprivation, so that, for example, in Congressional testimony Alice M. Rivlin picked a line at 125 percent of the official definition. One fourth of all children, she said, live in "near poverty households."[3] At one time, much was made of childhood poverty in the country that de Toqueville called child-

centered. As birth rates dropped and the women's movement gained ground, the issue came to be phrased as "the feminization of poverty."[4]

Either way, we begin with the one fifth of children who now live in single-parent families. A child born today has almost a fifty-fifty chance of spending a period of time with a single parent. These children and parents face a fierce array of economic handicaps. On the face of it, a single parent has only one wage to rely upon. Because single parents have, on the average, poor skills and education and because they are discriminated against, that wage is relatively small. Although the evidence is that they take virtually any job they can find,[5] their unemployment rate is high.

Child support helps only a little. In 1981 about a quarter of single mothers received child support --- an average of $2,100 a year.[6] The reasons are well understood. The income of the fathers is low, on the average. Many remarry and apply such income as they have to their new families. And courts often fail to hold fathers to stringent standards for support, either because courts are sensitive about the fathers' income or are responding to the power of the contest some fathers are able to wage. Over three decades and especially in the last four or five years, the federal government has moved with mounting force to compel the payment of support. Nevertheless, the proportion of mothers receiving payments declined between 1979 and 1981, the last year for which census data are available, and the average amount paid (adjusted for inflation) declined substantially. In net outcome half of the families of mothers with children are poor.[7]

Other causes for childhood poverty are low wages, underemployment and unemployment, family size, and the so-called family life cycle. It is a long-standing problem, identified years ago by Senator Paul Douglas, that a minimum wage earned full-time the year round, is not adequate to escape poverty for a family of four.[8] Moreover, in relationship to family need the minimum wage has been degraded over the last two decades. At $3.35 an hour, the minimum wage would not greatly have exceeded the 1983 poverty level for a family of <u>two</u> - $6,540. Thus, it should be no surprise that even among families in which at least one adult works regularly, those with children are more likely to be poor.[9]

A more general problem is the long-term erosion of the family wage. Until about 1960, it was thought that a man's wage or that of a single parent ought to be adequate for reasonable maintenance of a small family. Although many wives who came into the labor force in the 1960s felt that they were earning discretionary income, in succeeding years wives have come to feel that they are required to work. In part, that is because the average earnings of men, which had steadily been rising, stabilized in the 1970s and then for two or three years declined. In 1981, for example, the Agriculture Department estimated a moderate standard of living for a family of four at $25,400. At that time, the average industrial wage was $13,270. Two people working at the average industrial wage just managed a moderate standard of living --- if neither got laid off. Thus, minimum and average wages have declined relative to family living standards, posing a new or aggravated problem for those who undertake to support dependents.

Obviously, unemployment interrupts wages entirely and is even more damaging. Only a few states adjust Unemployment Insurance to family size so that, according to the National Commission on Unemployment Compensation, benefits that tend to be inadequate anyway are "least adequate for household heads..."[10] In general, one-third of the unemployed are poor; in March 1981, when the unemployment rate was 7.3 percent, 4 million children lived in two-parent families in which a parent was unemployed. That family size is a factor in poverty is virtually self-evident: three out of five poor children are in families that have three or more children.[11]

Poverty as Career. A textbook list of the qualities that cause childhood poverty provides little sense of the "career" or struggle that poverty represents. It is well understood that poverty runs a course, involving simultaneous crises on two planes --- family development and income development.[12] Four critical stages of this cycle are: 1) timing and circumstances of first marriage and child-bearing; 2) timing and direction of occupational choice; 3) family cycle squeeze --- the conflict of aspiration and need; and 4) family disorganization.

Early marriage (say, before a woman is 18) tends to be associated with low income, poor education, early childbearing and more children, and separation and divorce. Early marriage (or living together) is not an isolated judgment; it reflects the view of two youths about their life chances. Many youths who think they can get ahead economically will trade the instant satisfaction of living together for longer-term advantage. The experience of their elders and the current economic

climate affect their perception of this trade-off rather more than exhortation from afar. Early occupational choice ("hustling" included) is also counter-productive, and it tends to be forced by early marriage. Those who postpone settling into an occupation do so later more knowledgeably, with better contacts, and demanding a higher price for their work. Personal and family income are significant because education, moving where opportunities are, and even an optimum job search all cost money.

By their middle twenties, young adults have made interlocking decisions that bind them. Women have decided whether to go on in school or work, bounding what they may do later. For those who live where work is not to be found, these are the years when the decision is taken to move or to stay. Now families face the strain between income on one hand, and what is needed for maintenance and for realizing ambitions on the other - the family cycle squeeze.[13] Unfortunately, income tends to develop out-of-phase with family need. That is, income rises over the years with job progression, seniority, and greater freedom for mothers to work, but expenses are relatively highest in the early years. To cope with this problem, people may moonlight. Alternatively, they may try to restrict their need for income: spacing children or reducing their number is an obvious strategy. Other strategies such as borrowing money and piling up bills have evident limitations.

At this point, some people give up such aspirations as they may have had, and struggle for simple survival. Or the father (more usually than the mother) may separate from the family, possibly to try again.

education categories,"[15] which is to say that the struggle of a broad band of young American families for decent living standards and self-improvement is being described. In the light of the opening observation about middle income families, it may be understood that the issue about living standards and social overhead capital for young, non-poor families has lately become acute.

What Sort of Program? Current income maintenance programs, even if improved or redirected, would not readily resolve this issue of income in relation to family need and social overhead capital. Among the social insurances, survivors, disability, and unemployment insurance address childhood poverty. Parental death, for which survivors insurance was designed, is now far outranked as a risk by parental separation --- which Social Security does not address, of course.[16] Moreover, all the social insurance programs relate benefit payments to prior contributions or wages. In order to protect this principle, Social Security provides only moderate benefits for dependents and applies a so-called family maximum besides --- limiting the number of children for whom added benefits are paid to between 1.5 and 1.8 children. Most states, it has been noted, do not provide Unemployment Insurance benefits for dependents at all. The dilemma about how to provide decently for dependents while maintaining the broad concept of wage-related benefits is intrinsic to our concept of social insurance, unfortunately.

In addition, we have the means-tested programs --- food stamps, Aid to Families with Dependent Children (AFDC), and a number of smaller programs. By definition, they deal only with the most deprived and at

Little is quite so coldly calculated, of course. In the nature of the struggle, there has been plenty of frustration and conflict to account for separation. The mother and children may continue to struggle, but with the cards much stacked against them. This has been called the stage of family disorganization. In fact, the family may seem to get itself organized for the first time in years, but it is certainly handicapped.

Thus, we see the interrelationship of the choices that are made about work and family, how they flow together, and how the practical possibilities, including the sums of money that are or may be expected to be available, influence the choices. One perceives the relevance of a concept applied to developing countries. Take-off, W. W. Rostow once wrote, awaits "the build-up of social overhead capital," together with the necessary skills and a drive for improvement.[14] Take-off for poor families requires surplus money for investment in self-improvement, as well as the skill and drive more usually urged upon them.

Struggling to Get Ahead, Even When Not Poor, Is Also a Career. The same principles apply to all but upper middle class and wealthy families. Income starts out low for most workers and, if there are children, expenses relatively high. Child by child, the proportion of family income devoted to necessities like food and clothing rises and, even so, family living standards decline. Something must give: expenditures on recreation and transportation and social overhead capital decline. These observations appear to hold "across all age-and-

levels that are not far from pauperization, even in the best of times. They may prevent hunger but they do not provide --- indeed their policies may actively interfere with --- dignity and self improvement; and means-tested programs do nothing at all for children in families with moderate incomes.

Other western countries have social insurance and means-tested programs, as we do, and they have special programs for single-parent families that very modestly supplement their income. For example, every single parent in Britain is entitled to a so-called Child Benefit Increase. More to the point, all western, industrial countries except the United States have a basic program that provides a sum of money for every child without regard to income --- the family or children's allowance. These benefits represent a "significant percentage" of median wages, 5 to 10 percent when there is one child and substantially higher for single mothers and for families with several children.[17] Some countries provide instead or also an income tax credit for each child (Canada) or for a single parent (Australia).[18] The tax credit is payable as a tax refund to families that are --- because of low income --- not liable for taxes.

Inevitably, means-tested programs assume inverse importance in each country to the level at which children's allowances and other programs are provided. Thus, the United States spends more on such programs as AFDC and food stamps, in dollars or as a proportion of social benefits, than any other industrial country. In net outcome, in Britain and France the total income of single parents is half that of two-parent

families, but in the United States the proportion is only one-third. The system of children's allowances (or tax credits) and supplementary programs, taken together with other differences between countries, to be sure, leaves single-parent families and other families with children relatively better off in Britain and France than in the United States.[19]

There was a time when the absence of children's allowances in the United States was hard to explain;* a considerable case might still be made for such a program.[20] But time and changing social conditions probably make a refundable tax credit more desirable than children's allowances, while achieving similar objectives. On one hand, very large families --- the best case for children's allowances --- have become less common. For example, a typical AFDC family not so long ago contained three children; it now contains two.

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*The major reasons that children's allowances did not spread to the United States lie in history. In Europe, they were originally an employer strategy to depress wages. Subsistence wages were adjusted to family size, thus meeting the problem of larger families without providing a general wage increase. In the end, trade unions won general wage increases anyway and the program flourished to meet other purposes; European trade unions have for years supported them vigorously. However, American trade unions opposed them at a critical time. Moreover, children's allowances were long regarded in Europe as a device for raising the birth rate. In the European experience with such efforts after 1930 it became clear that that is not how babies get made, but public perception was not much altered. When government programs were expanding in the 1960s, Americans were preoccupied with a population explosion. We were not going to enact any measure that, however incorrectly, might be thought to make such a problem worse. Finally, it has widely been supposed that children's allowances would be a Catholic measure. It is only recently in American political process that such a view might not greatly undermine chances of enactment.

On the other hand, aged women (and aged men as well, but women far more urgently) rival children in the desperation of their need for income supplementation. In 1980, over half of aged women living alone had incomes defined as poor or on the borderline of poverty.[21] Upwards of another million belonged to the "hidden poor" - that is, those not counted poor only because of the income of those with whom they shared a household.[22] That is because many of the women never had their own income, because they earned less than men even if they had income, and because those who were married have outlived their husbands. Moreover, it is an unintended quirk of Social Security that the oldest of the aged, predominantly women, get lower average benefits than the younger aged. The problem is likely to grow more rather than less serious, because more are living to advanced ages.

Finally, changing demographic patterns combine with the increasing scarcity of public funds to produce predictions, not to say evidence of intergenerational conflict - a development not to be viewed lightly. It is attractive to meet the evident needs of the young and the old --- and of middle-aged people, who are perforce linked to the needs of children and the aged --- with a single public program.

Why It Is Their Turn. To sum up so far, families with children have for a long time represented a large portion of the poor population --- and that problem is growing. Even many middle income families with children are experiencing difficulty. In the nature of the stages

that families traverse, the least income is available when income is most needed. For a variety of reasons connected with the economy and government policy, these pressures are particularly acute now and will be for some little while at least. Even small sums that allow for maneuverability and investment in advancement are important to young families. Yet our extensive and, despite all difficulties, fundamentally successful social insurance system has been designed with an eye to individuals --- disabled, retired, unemployed, widowed, and orphaned individuals, but not families. It therefore deals poorly with children as dependents and misses many children - those with single parents, for example, entirely. Given the opportunity that arises, it may be time to address a program to children and their families.

The Refundable Tax Credit. A refundable tax credit is a credit against income taxes or a cash payment to the extent that income taxes are not owed. It is usually proposed as a substitute for the personal exemption in income taxes. Personal exemptions are worth more to those who pay a higher tax rate. That is, a $1,000 exemption is worth $500 to the person who reaches a 50 percent tax rate but only $200 to the one who earns less and is taxed at 20 percent. However, the $500 tax credit, or $200, or whatever is specified is worth the same amount to every taxpayer. That would seem to be less unfair. Current tax law contains an Earned Income Credit, but that is very modest, is available only to those with earned income, and only up to $10,000 of earned income.

A Proposal. An illustration of a feasible Refundable Tax Credit (RTC) may be outlined in beguilingly few words. Legislation would eliminate the $1,000 personal tax exemption and provide instead a $400 personal tax credit. Such a credit would be reduced by 5 percent of income in excess of adjusted gross income (AGI) of $10,000.* (AGI is taxable income minus a very few permissible adjustments such as moving expenses, IRAs and Keogh funds, and alimony paid.)

The existing Earned Income Credit (EIC) would be absorbed by this provision, that is, would no longer exist as a separate credit. Special exemptions for age and blindness would be eliminated. Under current law, it is permissible to file one's own individual return and be claimed as a dependent on another return as well, if the conditions for dependency are met. Such duplicate filing would be barred. People who do not owe taxes would be entitled to refunds, as now. If the refund exceeds some stipulated figure, perhaps $1,000, it might be paid out in quarterly shares.

Implications of this particular design may be elaborated as follows. The higher one's income, the smaller the gain from such a tax credit; at some point there is a loss relative to current law. For example, the current exemption is worth $500 to a person a portion of whose income is subject to a 50 percent tax rate. The credit proposed here is worth $400 per person. Moreover, the credit is reduced by 5 percent of income over

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*The proposal is written in relation to 1984 income tax law. Except where otherwise noted, dollar levels and other estimates represent 1984 law applied to 1982 income data.

$10,000 so that, for example, at taxable income of $14,000 the $400 per person credit due to a filer or household is reduced by $200 for the household; and the trade-off has altered. An elderly person forfeits a special exemption as well. Other variables include the level of deductions available and the family composition of the taxpayer. Taking all that into account, table 6.1 indicates the income level up to which various types of families would find the credit advantageous.

It is evident from table 1 that couples and families, families with children in particular, would benefit from the tax credit. (Median family income in 1982 was $23,430). Although the threshhold levels for the aged are lower than for younger people, their actual income is also lower. In 1980, for example, median income for aged individuals and couples, taken together, was $6,970.[23] Thus, in terms of the actual income of their age group, the elderly would benefit up to relatively high incomes. Also benefiting would be those families, usually with relatively low incomes,[24] with whom the "hidden poor" aged live. It appears that 60 percent of people who file a tax return would find the tax credit to their advantage --- see table 2. In addition, 5.5 million married couples and heads of households have incomes so low that they have not filed returns; obviously they would find the refundable credit to their advantage.

That there are a large number of gainers and of losers in the AGI class $20,000 to $30,000 is an indication that in this class, under the new provisions, larger families would gain and individuals or smaller families would lose. On the average, the latter would be losing $319 a year. The bulk of the gain, approximately $22 billion, would go to 52 million households with less than $20,000 a year. In addition, 5.5

Table 1

Levels of AGI at Which the Proposed Credit in Lieu of the Exemption Would be Advantageous (under 1984 tax law)

Type of Family on Return	Non-itemizer	Itemizer[1]
Single individual, under age 65	$14,000	$14,251
Joint return, under age 65		
One earner:		
No dependents	18,800	16,838
Two dependent children	24,400	25,397
Three dependent children	26,725	27,988
Two earners:		
No dependents	18,841	19,130
Two dependent children	24,864	26,041
Three dependent children	27,235	28,832
Single individual, age 65 or over	14,000	14,251
Joint return, age 65 or over	18,800	15,838

1. Assumes deductible expenses equal to 23 percent of gross income.

Source: Special analysis by the Office of the Secretary of the Treasury, Office of Tax Analysis, December 22, 1983.

million households that do not currently file tax returns would be eligible for approximately $5 billion in refunds. With a few exceptions, taxpayers with AGIs exceeding $30,000 would lose by the change. Those with incomes from $30,000 to $50,000 would average losses of $720 a year, those with incomes from $50,000 to $100,000 would average losses of $1,245 a year, and so on. Tax-free investments are concentrated in these latter groups, so that AGI is not nearly a complete reflection of their incomes.

The net cost to the government would be a little more than $7 billion a year --- $5 billion for current non-filers of tax returns and a net cost of $2.3 billion for filers (see table 2). One could reduce the estimated cost to the government by netting out savings in public assistance and other means-tested programs, but we choose not to do that. These programs have been severely degraded in recent years, in entitlement and in payment levels. Where savings are possible, first consideration ought to be given to improving them.

Seven billion dollars is a lot of money, even in the 1980s. However, a considerable argument can be made that the allowance for dependents, which this proposal addresses, is long overdue for improvement. While the cost of living (and thus the cost to a family of raising a child) has almost tripled in the last fifteen years, the value of the exemption for a dependent has increased from $600 to $1,000 or by only 67 percent. A comparison of 1948, when the exemption was established at $600, with 1979 when it first went to $1,000, would provide an even more dramatic contrast. Thus, there is a considerable case for improving the income tax treatment of dependents, one way or another. Moreover, as has been

Table 2

Effect of a $400 Per Capita Refundable Credit, Together With Repealing the $1,000 Exemption, the Earned Income Credit and the Aged and Blind Exemption, Distributed by Adjusted Income Class1/

Current Law tax Return Filers Only

(1984 Law, 1982 Levels of Income)

Adjusted gross income class	Number of returns	Returns with tax reduction				Returns with tax increase				Change in tax liability
		Returns		Tax reduction		Returns		Tax increase		
			As a percent of all returns	Total amount	Average amount		As a percent of all returns	Total amount	Average amount	
($000)	(thou.)	(thou.)	(percent)	($mil.)	(dollars)	(thou.)	(percent)	($mil.)	(dollars)	($mil.)
Less than 5	17,333	17,333	100.0%	$-7,817	$-471	0	0.0%	$0	$0	$-7,817
5 - 10	16,723	16,711	99.9	-6,695	-401	12	0.1	*	27	-6,695
10 - 15	13,836	12,197	88.2	-5,005	-410	1,586	11.5	97	61	-4,908
15 - 20	10,906	5,781	53.0	-2,478	-429	5,092	46.7	910	179	-1,569
20 - 30	16,882	4,162	24.7	-1,254	-301	12,693	75.2	4,047	319	2,792
30 - 50	14,288	130	0.9	-37	-286	14,113	98.8	10,200	723	10,163
50 - 100	3,713	2	0.1	-1	-533	3,622	97.5	4,511	1,245	4,510
100 - 200	641	0	0.0	0	0	599	93.5	987	1,647	987
200 and more	177	0	0.0	0	0	155	87.6	269	1,740	269
Total	94,500	56,317	59.6%	-23,288	$-414	37,873	40.1%	$21,021	$555	$-2,267

Note: Details may not add to totals due to rounding.
*Less than $500,000.

Source: Special Analysis by the Office of the Secretary of Treasury, Office of Tax Analysis, December 22, 1983.

pointed out, this proposal is put forward in a context in which some improvement for lower income people is likely to be viewed as a necessary tradeoff for generally increased taxation and revenues.

Achievements of an RTC. We conclude by reviewing what an RTC would achieve in the light of the family stresses and problems of public policy that have been outlined.

1. With respect to poverty and the chronically poor fit between the minimum wage and family need: An indication of the effect of the program on poverty among the aged and families with children may be found in estimates of its effect on the caseloads of the public assistance programs to which, perforce, they resort. In 1980, a Refundable Tax Credit as described would have provided at least equivalent income (in many cases, more income) to a quarter of the aged individuals and a third of the aged couples benefiting from Supplemental Security Income (SSI).[25] That is, they would not have had to apply for SSI. For a variety of reasons connected with program administration and the way statistics are reported, it is more difficult to estimate the effect on AFDC recipients. One may hazard the guess that 25 percent of AFDC recipients would receive at least as much from the refundable credit as from AFDC --- with how much less administrative expense and hassle all around!

As for poor families that do not qualify for AFDC, a couple with one member working full time at the minimum wage has about $7,000 in earnings and, if they have two children, may receive $370 as Earned Income Credit. Instead, they would receive $1,600 from the RTC. The poverty line is just under $10,000, so the credit would bring them half-way to the poverty level. Obviously something remains to be done --- by a general movement

of wage levels to the point where a full-time wage supports four people at the poverty level, as in past decades: or, for any particular family, by part-time or full-time work by the second adult (granted that the suggestion may be gratuitous).

2. With respect to the struggle of moderate- and middle-income families for social overhead capital, an indication of the effect of an RTC may be found in considering the circumstances in 1972-73 of a family of four that had income of about $9,000 (equivalent to $20,000 ten years later).* Those were comparatively favorable years in terms of growth of GNP and unemployment rate, which is to say that families were operating in a favorable economic climate. On the average, this group of families had two children; the family head was 35 years old. Their liquid assets (savings and checking accounts and stocks and bonds at market value) declined by a little less than $80 (equivalent to $180 a decade later) per year.[26]** Thus one sees the financial pressure on such families, even at income levels approaching average.

At their income level, personal exemptions would be worth something less than $600 to each family but the RTC about $1100. Thus, the tax credit would convert a $180 yearly loss in liquid assets into a $320 gain. It is a modest but respectable improvement in maneuverability. How much more is this so for families that, because of unemployment, lower income, or more responsibilities, experience even more so-called dis-

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*1972-73 is the last period for which consumer expenditure data have so far been published. Family income is a figure a little larger for these families than AGI.

**At the end of the year, liquid assets for these families amounted in total value to $2,227 (just over $5,000 in 1982-83 dollars).

saving. Obviously, such families would show a larger gain from the Refundable Tax Credit.

3. With respect to the dilemma in social insurance about relating benefit payments simultaneously to prior contributions and to family need: The Refundable Tax Credit would act for social insurance, as indeed more broadly, as an adjustment for family size. For example, each child entitled to survivors insurance who is in a one- or two-child family currently receives 50 percent of the parent's benefit, but children in three-child families receive only about 25 percent, on the average. Another indication of the inadequacy of social insurance benefit levels, considered in family terms, is that 4 percent of cases receiving AFDC are also receiving social insurance payments. Broad movement to an RTC would moderate the need created by dependents and leave Social Security and Unemployment Insurance free of the requirement to respond to these differences. Benefit payments could plainly be seen to be related to prior contributions or prior work without, at the same time, leaving families with children in need.

4. From the perspective of each affected family over time, it may be evident that younger families with children would receive more under such a program but would, when earnings had approached a peak and children had left home, pay higher taxes than now. They would, in effect, have loaned money to themselves in a straitened period out of their own, more prosperous future. And this loan to themselves - social overhead capital - would help them to make that future prosperous.

NOTE: It may be obvious that a variety of alternatives are available in designing a Refundable Tax Credit. A supplement to this paper, available by writing to the author, names as possibilities:

retaining special exemptions along with an RTC, providing a credit at a level of $500 per person, and providing the refundable credit as an elective alternative to the personal exemption --- at the taxpayer's choice. Data on costs and distributive effects are available in the supplement.

Second, this analysis has not attempted to deal with tax administration, per se, but it may be recorded that the RTC would move in a direction long urged by those who write, administer, and litigate tax law. The virtually self-defining entitlement to a credit would replace complex definitions of dependency and special tax tables. With respect to simplification and, particularly, with respect to questions of tax equity, see reference 27/.

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Supplement to:

"Women and Children Last..."

--- Alvin L. Schorr

Journal of the Institute for Socioeconomic Studies, June 1984

Alternative Options for a Refundable Tax Credit

One might consider changing many of the design details of the proposed RTC. Special exemptions for age or blindness or the Earned Income Credit might be left intact, providing a larger gain for each respective group of people and reducing opposition to the proposed program. Of course, the cost to the government would increase. The special exemption for blindness represents a small cost - $45 million; the special exemption for age and EIC are more consequential. The former is estimated to represent a cost in 1984 of $2.5 billion in revenue foregone. (See Table 5) The EIC represents a cost in revenue foregone and payout in 1984 of $1.5 billion.1/

One may also entertain other tax credit levels; presumably tax credit levels would increase over time in any case. The consequences of a $500 per person tax credit are indicated in Tables 3 and 4. More people would gain (68 percent versus 60 percent) up to somewhat higher AGIs, and fewer would lose. The net cost to the government would be considerably higher --- something over $20 billion for people now filing returns and in excess of $6 billion for current non-filers, a total of about $27 billion in all.

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An Elective Refundable Tax Credit.

An interesting alternative would be to phase in a Refundable Tax Credit on an elective basis. Legislation would provide that individuals or families filing a tax return might elect to receive a Refundable Tax Credit of $400 per person in place of the $1,000 personal exemption currently available. Other provisions --- reduction by 5 percent of income in excess of AGI of $10,000, elimination of special exemptions, and so forth --- would then apply. Those who chose not to take the elective option could continue to use personal exemptions, as under current law. Once the new provision were elected by a person filing a tax return or elected on behalf of a dependent, however, that person and dependent would not again be able to claim a personal exemption. With the elective credit, no one would lose in the short run, for potential losers would simply retain the exemption. As the credit is designed to benefit people at an age and in circumstances when they really need it, over a period of time virtually everyone might be expected to participate. Eventually, with relatively little pain, the provision could be made mandatory.

Unfortunately, as table 5 indicates, the short-term cost to the government would be high --- $24 billion for those who now file returns and perhaps $5 billion more for non-filers. Table 6 provides comparable figures for a $500 elective refundable tax credit. As more and more people are covered by the election of a tax credit and when and if a transition is made to dropping personal exemptions entirely, cost to the government would more closely resemble those in Tables 2 and 4.

Table 3

Levels of AGI at Which the Proposed Credit in Lieu of the Exemption Would Be Advantageous (under 1984 tax law)

Type of Family on Return	Non-itemizer	Itemizer1/
Single individual, under age 65	$15,625	$16,000
Joint return, under age 65:		
One earner:		
No dependents	21,644	22,426
Two dependent children	29,962	30,862
Three dependent children	33,088	34,815
Two earners (each spouse earns 50 percent of total income):		
No dependents	22,136	22,800
Two dependent children	30,038	31,508
Three dependent children	33,720	35,419
Single individual, age 65 or over:		
Without age exemption	15,625	16,000
With age exemption	16,000	16,086
Joint return, age 65 or over:		
Without age exemption	21,644	22,426
With age exemption	22,533	22,820

1/ Assumes deductible expenses equal to 23 percent of gross income.

Source: Special analysis by the Office of the Secretary of the Treasury, Office of Tax Analysis, December 22, 1983.

Table 4

Effect of a $500 Per Capita Refundable Credit, Together With Repealing the $1,000 Exemption, the Earned Income Credit and the Aged and Blind Exemption, Distributed by Adjusted Gross Income Class 1/.

Current Law Tax Return Filers Only

(1984 Law, 1982 Levels of Income)

Adjusted gross income class	Number of returns	Returns with tax reduction				Returns with tax increase				Total change in tax liability
		Returns		Tax reduction		Returns		Tax increase		
		Number	As a percent of all returns	Total amount	Average amount	Number	As a percent of all returns	Total amount	Average amount	
($000)	(thous.)	(thous.)	(percent)	($mil.)	(dollars)	(thous.)	(percent)	($mil.)	(dollars)	($mil.)
Less than 5	17,333	17,333	100.0%	$-10,137	$-585	0	0.0%	$0	$0	$-10,137
5 - 10	16,723	16,723	100.0	-9,654	-577	0	0.0	0	0	-9,654
10 - 15	13,836	13,498	97.6	-7,759	-575	337	2.4	24	73	-7,735
15 - 20	10,906	7,343	67.3	-4,603	-627	3,519	32.3	493	140	-4,110
20 - 30	16,882	8,149	48.3	-3,906	-479	8,693	51.5	2,401	276	-1,506
30 - 50	14,288	1,252	8.8	-379	-302	12,993	90.9	7,572	583	7,194
50 - 100	3,713	9	0.2	-4	-395	3,617	97.4	4,362	1,206	4,358
100 - 200	641	*	*	-*	-*	599	93.5	987	1,647	987
200 or more	177	0	0.0	0	0	155	87.6	269	1,740	269
Total	94,500	64,309	68.1%	$-36,442	$-567	29,914	31.7%	$16,109	$539	$-20,333

Note: Details may not add to totals due to rounding.
*Less than 500 returns, .05 percent, $500,000, or $.50.

1/ The credit would phase out at a 5 percent rate for adjusted gross income in excess of $10,000.

Source: Special analysis by the Office of the Secretary of Treasury, Office of Tax Analysis, December 22, 1983.

Table 5

Effect of an Optional $400 Per Capita Refundable Tax Credit in Lieu of the $1,000 Exemption and Repealing the Earned Income Credit, Distributed by Adjusted Gross Income Class

Current Law Tax Return Filers Only

(1984 Law, 1982 Levels of Income)

Adjusted gross income class	Current law tax liability		Tax liability under an optional $400 per capita refundable credit in lieu of the taxpayer and dependent exemption, with the earned income credit repealed					
			With the exemption for the aged and blind repealed			With the exemption for the aged and blind allowed		
	Amount	Percentage distribution	Amount	Percentage distribution	Change from current law	Amount	Percentage distribution	Change from current law
($000)	($mil.)	(percent)	($mil.)	(percent)	($mil.)	($mil.)	(percent)	($mil.)
Less than 5	$-13	-*%	$-7,830	-3.5%	$-7,817	$-7,903	-3.6%	$-7,890
5 - 10	4,950	2.0	-1,745	-0.8	-6,695	-2,213	-1.0	-7,163
10 - 15	13,129	5.4	8,195	3.7	-4,934	7,782	3.5	-5,347
15 - 20	17,749	7.3	15,463	7.0	-2,286	15,183	6.9	-2,566
- 30	45,402	18.6	44,581	20.1	-821	44,142	20.1	-1,260
- 50	72,645	29.8	73,036	32.9	391	72,608	33.1	-37
- 100	44,629	18.3	44,865	20.2	236	44,628	20.3	-1
100 - 200	22,336	9.2	22,417	10.1	81	22,336	10.2	0
200 or more	22,874	9.4	22,907	10.3	33	22,874	10.4	0
Total	$243,702	100.0%	$221,889	100.0%	$-21,812	$219,436	100.0%	$-24,265

*Less than .05 percent.
Note: Details may not add to totals due to rounding.

Source: Special analysis by the Office of the Secretary of Treasury, Office of Tax Analysis, December 22, 1983.

Table 6

Effect of an Optional $500 Per Capita Refundable Tax Credit in Lieu of the $1,000 Exemption and Repealing the Earned Income Credit, Distributed by Adjusted Gross Income Class

Current Law Tax Return Filers Only

(1984 Law, 1982 Levels of Income)

Adjusted gross income class	Current law tax liability		Tax liability under an optional $500 per capita refundable credit in lieu of the taxpayer and dependent exemption, with the earned income credit repealed					
			With the exemption for the aged and blind repealed			With the exemption for the aged and blind allowed		
	Amount	Percentage distribution	Amount	Percentage distribution	Change from current law	Amount	Percentage distribution	Change from current law
($000)	($mil.)	(percent)	($mil.)	(percent)	($mil.)	($mil.)	(percent)	($mil.)
Less than 5	$-13	-*%	$-10,150	-4.9%	$-10,137	$-10,224	-5.0%	$-10,211
5 - 10	4,950	2.0	-4,704	-2.3	-9,654	-5,172	-2.5	-10,122
10 - 15	13,129	5.4	5,394	2.6	-7,735	4,982	2.4	-8,147
15 - 20	17,749	7.3	13,260	6.4	-4,489	12,980	6.3	-4,769
20 - 30	45,402	18.6	41,892	20.1	-3,510	41,453	20.1	-3,949
30 - 50	72,645	29.8	72,693	34.9	48	72,264	35.1	-381
50 - 100	44,629	18.3	44,862	21.5	233	44,625	21.7	-4
100 - 200	22,336	9.2	22,417	10.7	81	22,336	10.8	-*
200 or more	22,874	9.4	22,907	11.0	33	22,874	11.1	0
Total	$243,702	100.0%	$208,572	100.0%	$-35,129	$206,119	100.0%	$-37,582

*Less than .05 percent or $500,000.
Note: Details may not add to totals due to rounding.

Source: Special analysis by the Office of the Secretary of Treasury, Office of Tax Analysis, December 22, 1983.

Mrs. SCHROEDER. I thank the whole distinguished panel.

Do any of you want to respond to each other? I thought you might, Mr. Carleson.

Mr. CARLESON. Well, I don't want to make too many points on this. Obviously, the only two quick responses to Mr. Minarik—and I think he did a very good job of laying out exactly what the system is and pointing out a couple of the problems with the earned income tax credit. Both of those problems however are not unusual.

The first problem was that some people may take it in a lump sum rather than getting it on a regular basis like you can in, say, welfare programs. Well, of course, we did change the law some time ago to permit exactly what he wants, and a lot of people are taking it on that basis.

I might indicate that any kind of a proposal such as Mr. Schorr presented would have exactly that same question and that same problem.

The other thing I would note would be the fact that a lot of people who may be eligible don't apply. That is true in all programs. That is true in food stamps. That is true in AFDC. It's true in SSI. It's true in everything.

It is not true because it's difficult. The earned income tax credit for a lower and middle income person provides for a very easy way to apply. You can't make it any easier by changing it into a refundable tax credit for everybody.

So, those two problems mean nothing. But I think the heart of our differences here, if we are looking for differences, and there apparently are between Professor Schorr and me, is the fact that what I am proposing is related to taxes. In other words, we are talking about the tax code, the tax laws, the taxes people pay. The earned income tax credit goes up from a minimum of 45 percent for one child to 130 percent, just in the example that I gave, for families with four children. We are talking about a system where we can maintain the purity of it being a tax system. The refundability of the earned income tax credit is a refund of a payroll tax that those people worked and earned.

I think it is extremely important to keep that integrity. It is not a welfare payment. The word refundable, when used in this sense, in the earned income tax credit, is correct. It is a refund of taxes paid. The word refundable, as used in the context of Professor Schorr's plan, is not refundable, because you are not refunding any taxes that were paid. It is, in effect, a welfare program. One of the things that bothers me about it, particularly in light of some of your statements at the start of the hearing, Madam Chairperson, is the fact that apparently it would result, Mr. Shorr's plan would result, in effect, to a taking from middle-income families with children and giving to no income or lower income families.

It is just a fairly simple income redistribution program, because you not only would limit and change it to a tax credit from a tax exemption, which would have the effect of moving income from middle and upper income families through that process, but then would actually reduce the credit by 5 percent of income in excess of adjusted gross income of $10,000. So, that means that families with incomes over $10,000 would have their tax credit, reduced by 5 per-

cent of income in excess of the adjusted gross income. And 5 percent of income in excess of adjusted gross income of $10,000 could wipe out the $400 tax credit in a very short period of time.

So, if we are talking about families, not only poor families but also middle income families, I think we should stay within the tax code and treat this as a tax problem not a welfare problem. If we want to deal with families who have not paid into the tax system, either through the income tax or through the payroll tax, then I think we should concentrate our efforts over in the Social Security laws and in the welfare laws, as Senator Moynihan suggested.

Mrs. SCHROEDER. Mr. Minarik or Mr. Schorr, do you want to respond rapidly?

Mr. MINARIK. I would just add one thing. I think Mr. Carleson is correct. The problems of the earned income credit are the same in nature as the problems of some of our transfer programs.

There is some indication, as I understand it, that in terms of the usage of the earned income credit, it's a little bit worse in terms of lower take-up rates, lower inclusion of eligible people, compared to programs like AFDC.

I think Mr. Schorr is correct when he says that the earned income tax credit is fairly complicated for low income people trying to file. I can say from every now and then pulling out that page of the tax booklet and trying to figure it out just to see what somebody trying to do it would be experiencing. It is a pretty difficult piece of computation.

Mr. CARLESON. Except they can check the box that says that they can let IRS figure their tax for them, and then they don't have to use that form. That form is really only needed when people are itemizing, and so forth, is the way I understand it.

Mr. MINARIK. That's true, but, to someone who does not really understand the system and has the stack of papers in front of him, one has to worry about the intimidation factor, the possibility that the person is just going to throw up his hands and turn away. And there is that danger. That may be contributing, to some degree, to the reduction in take-up rates.

In the past there have been some out-reach programs for the earned income tax credit. I have seen television commercials for the earned income tax credit. That may be part of what is necessary to get people to understand what it is and to staple their 1040 to the form, mail it to the Internal Revenue Service and say "help". And if they do that, they will get the credit. But that may be a leap from where we are now.

Mr. SCHORR. Well, I guess I would like to say that I think that every tax bill is a redistribution bill. That's what all the fuss is about.

For example, the Omnibus Reconciliation Act of 1981 transferred $36 billion to the top 20 percent of the population. That is income redistribution. I am not quarreling with that. I merely say that every tax bill redistributes income, and that is why there is so much passion about it.

The administration's proposal, and Congressman Kemp's proposal would spend more than $30 billion improving the personal exemption to the disproportiniate advantage of upper income groups.

I do not regard that as more cleanly and neatly a tax issue than $2 or $3 or $20 billion for the poorest income groups.

It interests me that, we seem to box the poor into a special requirement that they not seek redistribution. I think we should deal as nearly as we can with everybody on the same basis.

Mrs. SCHROEDER. Congressman Evans, do you have some questions?

Mr. EVANS. I thank the Chair.

I have a question, Mr. Minarik. You have looked at the exclusion of employee pay benefits from a tax point of view. We are also concerned in this committee about looking at the impact of including that income for working people in terms of its impact on health care. There are people that say that this country has chosen to limit access or only give access through the tax policy to health care.

Have you looked at it from the point of view of what it would mean for availability of health care for those people if in fact it was included in income?

Mr. MINARIK. Well, the first thing to keep in mind is, if you included employer's health insurance premiums paid on behalf of the employee in the employee's income, that would make absolutely no difference to the employer's tax consequences. The employer can deduct those premiums today, just as he does the cash wages that he pays. The way the system works today, those premiums are mad money; nobody pays taxes on them. And I think that that is the problem.

So there is no logical reason why it should change the employer's choices to offer or not to offer insurance.

Mr. EVANS. Have you looked at the issue of parents who used airline tickets? I am not sure of the exact issue, but I think the Deficit Reduction Act of last year included parents who had been receiving fringe benefits from airline tickets through their children. They are now not paying—the employers are not offering those fringe benefits. That, I guess, would have been a little more extravagant than health care. But I am wondering if, even though the employer has been able to deduct it, are they in fact going to offer it because of their reporting requirements, and so forth, on the employer's part?

I wonder what kind of climate this creates in terms of negotiations between, let's say, a union and an employer. Doesn't it make it harder for a union to bargain with an employer if those kinds of administrative burdens are imposed under the tax code?

Mr. MINARIK. Well, I think there are a couple of issues here.

In terms of the administration, the employer has to pay a carrier in order to provide that coverage. There is a price for the coverage for the employee. If that price is what is taxable to the employee, then the additional burden to the employer equals putting that amount of money onto the employee's W-2 form.

I don't think that that is a serious issue in terms of what the employee takes.

Now, the employee when he goes to bargain with his employer, will look at those choices in a different light. I don't think there is any question. I would be very much surprised if dental insurance were as popular if those premiums were taxed. The way the system

works right now, if you look behind the surface, the benefit of dental insurance is nothing like the benefit of medical insurance. There are no really catastrophic dental needs. The problem with people's teeth is that everybody needs their cavities filled. You buy dental insurance through your employer for a tax advantage. It is quite possible that employers and employees in bargaining would decide if I have to pay taxes on that, I will go to my own dentist and I will take care of them.

As far as health insurance is concerned, however, when you look at the fundamentals, catastrophic coverage, and so forth, the evidence that I have seen suggests that there really isn't much likelihood that employees would turn down catastrophic medical insurance because they had to pay tax on the premium.

In the Bradley-Gephardt proposal, for example, the basic rate of tax is 14 percent, and all health insurance premiums are taxable in full. So, if an employer buys an employee $2,000 worth of catastrophic medical coverage, it is going to cost the employee $280 in taxes to get that insurance. I think most people would agree $280 in tax paid for $2,000 worth of insurance is kind of a bargain.

I think that the issue here is, are you going to look at the person who gets that insurance in isolation and say you want to do him a favor, which is nice, and everybody would like to do that; but, you know, think about the burden that you have to impose on the other guy who doesn't get that insurance.

Keeping in mind that most consumers are rational and are going to want to get catastrophic insurance and the basics of insurance, they might look at co-payments. They might look at whether insurance should be comprehensive and cover office visits, or whether they will pay for the office visits and take care of the hospital with insurance.

I do not think that it is as much of a change of employer-employee choices as some people allege.

Mr. EVANS. Maybe I got the question turned around. Maybe I should ask you from the view of a person in a nonunion plant or somebody organizing a plant, where those health care benefits are already provided. Although even under these changes the employer would be able to deduct those expenses, isn't that a further burden for the proposed union trying to get a health care plan through maybe a nonunion plant at a particular time?

In other words, I am worried about the lack of availability of health care anyway. To further put a burden on an employer through recording and so forth would make it harder for people trying to organize a plant or trying to get that, even a nonunion plant, trying to get an employer to agree to do it. Would you see that as a potential problem?

Mr. MINARIK. Well, if you look at the current system, and consider a situation where an employee group has not been able to negotiate for health care, where it's a freebie, and there is no tax liability to anybody, how much more likely or less likely are they going to be to get it under a system where it is, in fact, taxable?

I don't think the accounting for the employees' benefits is such a tremendous burden. Under that kind of a system, an employee who now doesn't get those benefits gets a tax cut in the first instance through rate reduction, through larger exemptions and standard

deductions, and so forth. So, he's got more to bargain for. And when he goes to the employer to make the bargain, it's really a choice: is it going to be cash compensation, or is it going to be insurance.

For the employer, total compensation is his budget. That's his bottom line, and that's what he has to meet. It is just a choice of how you pay it out. I don't think there is that much of a difference in that kind of a bargaining circumstance.

Again, I continue to think that the argument against taxing fringe benefits really exaggerates the difficulty in dealing with that issue on the employer-employee level.

Mr. EVANS. No further questions.

Mrs. SCHROEDER. Thank you.

Mr. SCHORR. Could I respond to Mr. Evans in this way? From the purview of this committee and of the interest of children, it's worth taking into account what is generally going on in the field of health care. There are now 35 million people without health insurance coverage of any kind, and a lot of financial pressure on these young families. Studies make it very clear that, when pressed, they spend what they have for rent and food and utilities. And they yield up those things that, in those circumstances, are regarded as less a matter of survival.

In that context, it compounds the problem of coverage to create a situation in which fewer people are covered for health care in some relatively automatic way. There can be no doubt that taxing health benefits would tend to create such a situation. Maybe when the economic circumstances of young families greatly improve or Congress has set in place ways to correct the restriction of medical care that is now occurring around the country, one would move to tax health benefits. But to move in that direction now strikes me as edgy, particularly for children.

Mr. MINARIK. Could I ask Mr. Schorr a question?

It seems to me there are two ways to respond to that situation. One is to leave the current tax treatment of health insurance in place, which hasn't done those people any good. Two is to give those people a tax cut. And the best way to give them a tax cut is to put them on an equal footing with respect to the tax system with the other workers who do get that insurance, and then reduce the rates and increase the exemptions across the board in order to raise the same amount of revenue. Under those circumstances the people you describe are going to be getting a tax cut, which I think they deserve.

Mr. SCHORR. In some ways, your comment deals with a black box—that is, what Congress will do. But Congress will, after all, do what it will do without regard to exactly how you and I made up our minds about this.

In some contexts I would agree with you that one should tax health benefits if, in return, lower income families wound up with enough income, really enough income so that they were free to buy health benefits. Right now, I find that outcome hard to visualize.

Mrs. SCHROEDER. I would like to summarize by just saying would it be fair to say that all of you, though, agree with Senator Moynihan's analysis that the whole tax burden has shifted more and more to families?

Mr. CARLESON. I don't want to agree with everything, but I think yes, there has been a shift away, because of the erosion of the exemption and so forth, and also because of the increases in the payroll tax. I think that whenever anybody makes an analysis of whether the poor are paying more now than they were before the last few years, anything that shows that they were paying more is almost always limited to the increase in the payroll tax, not in changes in the income tax.

This is one of the reasons why I feel so strongly about really improving the earned income tax credit. You know, I come from what is generally considered an unusual point of view to make these kinds of recommendations, but it really isn't unusual. We were making these recommendations back in 1972. The important reason we are able to do it and have it become accepted is the fact that it is tax relief. If we can make these kinds of changes, we can correct some of the problems that Senator Moynihan and I know you are worrying about.

Mrs. SCHROEDER. Well, I want to thank the distinguished panel for being here. I hope you didn't mind my having you bounce off each other, but sometimes that is the most interesting way to proceed. It makes for a more interesting record.

Thank you very, very much. I appreciate your trying to help us as we steer our way through this.

I must also say there is a more expensive dental care. I just paid $6,000 for my son's new designer teeth.

We now welcome our next witness, Marian Edelman, who has been fantastic. We all know of her very, very good work dealing with children and their families and their condition in this economy.

Welcome. We will put your statement in the record.

STATEMENT OF MARIAN WRIGHT EDELMAN, PRESIDENT, CHILDREN'S DEFENSE FUND, ACCOMPANIED BY MARY BOURDETTE AND JAMES WEILL

Ms. EDELMAN. Thank you. I have brought with me to answer any questions Mary Bourdette and Jim Weill. Mary is our legislative director, and Jim is our legal director. They did most of the work on the new report on the Federal tax policy on poor families.

I assume that members of the committee have that report.

Mrs. SCHROEDER. Yes; we do. We appreciate that.

Ms. EDELMAN. I am glad that the poor are getting their hearing in the Congress. I appreciate the Select Committee on Children, Youth, and Families providing this opportunity to us and to others to talk about the increasing tax burden on the poor.

Obviously, the poor have been hit in two directions. They have suffered disproportionately from the cuts in the benefit side while the Federal tax burden on low-income individuals and families has increased dramatically in the last few years.

As an example, who we call Jane Doe, is a single mother with three children. In 1979 her income from her job was $8,000, a little bit above the Federal poverty line. Like most of the low-income workers, Jane Doe had no unusual tax deductions or tax breaks. So, her Federal income tax and Social Security taxes were $481,

which left her family with $7,519 to live on, after Federal taxes, still a tiny bit above the official poverty line in 1979.

But from 1979 to 1984, inflation increased the cost of living by 43.2 percent. The poverty line increased at the same rate, from $7,412 to $10,613 for her family of four. Despite the recession, she kept her job. She received salary increases equal to the cost of living change. And her 1984 salary was $11,456.

She would be in the same financial situation as she was during 1979 except for two things. First, many of the small governmental benefits that used to go to some working poor parents and their children have been reduced or eliminated since then because, in my view, of the misguided budget priorities that this Congress has accepted from the Reagan administration.

Second, her taxes have skyrocketed. In 1984 Jane Doe's Federal taxes were $1,384 on her $11,456 income. While her salary went up 43.2 percent, her taxes nearly tripled from 1979 levels. Instead of her being slightly above the poverty level when she began, she fell to just about 95 percent of the poverty level in 1984. So, in effect, Federal taxes virtually impoverished this poor working single mother and her children.

Now, she is like a lot of other poor folk in her problems. Single mothers, I think, and single parent heads of households face an unfair burden. I think the unfairness of what happened to her is a result of the economic policies of the Reagan administration. Almost everybody else got tax breaks. The rich did, rich individuals and rich corporations, while Jane Doe was getting increasingly burdened.

Some huge profitmaking corporations, in fact, not only got to pay no income taxes, but they began to get tax payments back from the Government. She paid, in paying her $1,384, Jane Doe paid more Federal taxes in 1984 than Boeing, General Electric, Dupont, Texaco, Mobil, and AT&T all together paid in Federal income taxes in 1983, although these huge corporations earned $13.7 billion in profit.

I get a special annoyance from Mr. Grace, who is heading up the W.R. Grace Commission and who is campaigning, as we all would agree, on eliminating fraud and abuse. But he is also seeking more cuts in social welfare programs that affect the Jane Does of our society. We were rather surprised to learn that W.R. Grace Co. not only paid no net Federal income taxes between 1981 to 1983, even though they made $684 million in profit; they actually got back $12.5 million in negative taxes through rebates or sale of excess deductions to other corporations.

There is just no principle that would make this fair. I think this is absolutely intolerable. The Congress really must take steps to correct it.

Over 35 million Americans, more than 15 percent of the population, live in poverty today, especially female head of households are affected. Nearly half of female-headed families with children were poor in 1982. The majority of children living in poverty in this country are part of female-headed families. Nearly half of all poor single mothers with children attempt to support their families with their own wages, and three-quarters of all other poor families have income from earnings, which are thus subject to Federal taxation.

One of the great myths in this country is that the poor pay little or no taxes. I think that we at least in this hearing and in other things are now beginning to correct this myth. Individuals and families with inccme below the poverty level are paying significant and increasing shares of their meager incomes.

In 1982 about half of all individuals and families living in poverty paid Federal taxes. The Federal taxes paid by poor families increased 58 percent from 1980 to 1982.

The number of persons in poverty paying Federal income taxes more than doubled in this same period. As I pointed out earlier, this has happened at a time when they were losing their Federal benefits because of unjust budget cuts.

It is estimated that most low income working families earning poverty level wages will pay between 9 and 12 percent of their income in Federal Social Security and income taxes in 1984. We point out on page 18 of our report, for example, that a four-person family, two parents and two children, with an earned income at the 1984 poverty line of $10,613 paid $1,076 in combined income and Social Security taxes. This same family in 1979 paid less than 2 percent of their income in Federal taxes, and all that was in Social Security.

This family's combined Federal tax burden as a percentage of income more than quintupled during this period. You can just imagine what would have happened if we had attempted to take similar steps that affected the middle class and the upper classes.

Single parents particularly again faced an even more unfair burden. As you know, one of the things that we call for as a priority is that we eliminate the differential between the tax burden faced by single mothers or single families and those of two-parent families. And large poor families also face a disproportionately high tax burden under the current tax system.

What is it that should be done? It seems to me that at a time when this Congress has passed the largest income tax cut in history that immediate steps must be taken to lower the tax burden of the poor. The income tax threshold, as we pointed out for Jane Doe, is one of the things that we think should be raised. The income tax threshold, which is the income level at which families begin to pay taxes, was above the Federal poverty level in the late 1970's, but it is now well below the Federal poverty line.

The income tax threshold for poor families is ultimately determined by the personal exemption, the standard deduction, and the earned income tax credit. For working families in poverty and those just above the poverty line, the failure to adjust the personal exemption, the standard deduction, and the earned income tax credit amounts in 1981 more than offset any positive effects that occurred in the cuts in the income tax rates. As a result, we estimate that generally families earning below 160 percent to about 210 percent of the poverty line paid higher effective tax rates in 1984 than in 1979.

The closer the family's earnings to the poverty line were, the larger was the increase in their effective tax rates. This inequity must be remedied.

We think that fairness and equity demand an immediate and sharp reduction in this tax burden on taxpayers struggling to sup-

port their families on low wages. We call for improvements in some or all of those tax provisions affecting families in poverty: the personal exemption, the standard deduction, and the earned income tax credit.

In our children's survival bill, which will be introduced shortly, which is our omnibus legislation agenda for children and families, which Chairman Miller and others will be sponsoring, we set out a tax agenda for the working poor by including several proposals essential for tax relief and fairness for those least able to pay. I would just like to summarize them very briefly and then end.

First and foremost, we recommend that the earned income tax credit, the one tax provision exclusively available to poor working families with children, be significantly expanded. It was developed in 1975 as a work incentive for families. It is a refundable credit. It may be utilized to exempt low income working families from Federal income taxes. And it can offset a heavily regressive Social Security tax as well. Our proposal seeks to expand eligibility for the EITC to families earning up to $16,000 a year and to increase the credit itself on a sliding scale to a maximum of $800. This proposal would provide much needed tax relief to working families in poverty, exempting most of these families from income taxes and for many offsetting a portion of Social Security taxes.

We estimate that this would cost about $3 billion, which is not a whole lot more than we now lose through the two-martini deduction for business lunches.

Second, the EITC must be indexed for inflation. It is the only major tax provision affecting rates that is not scheduled for indexing this year, despite the fact that its value has eroded substantially. Unless it is indexed, Federal taxes on the poorest working families will continue to increase in future years.

Third, the EITC currently depends only on income and is unrelated to family size. An eligible family of five receives the same credit as an eligible family of three. We thus recommend increasing the EITC with an allowance for each dependent child and an additional amount for each child under six. This would help large poor families, and it would also help families with young children with child care costs.

Fourth, the standard deduction should be increased. In 1984, as in 1979, the standard deduction was $2,300 for single persons. It was $3,400 for married couple families. It is scheduled for indexing in 1985. Expanding this deduction would primarily benefit low-income taxpayers. And there are many moderate income taxpayers who similarly do not itemize deductions and would benefit from an expanded standard deduction. Obviously, we favor eliminating the $1,100 differential between two-parent households and those who are single-parent households.

Finally, we propose that the dependent care tax credit be expanded and made refundable. As you know, the dependent tax care credit is an important element of Federal support for child care. Expanding the credit would offer increased assistance to many working families in need. Making the credit refundable would ensure that lower income families could take full advantage of it.

I know that you have put in some proposals to provide for tax relief, and there are a few pending tax plans which are getting se-

rious consideration. It is possible, as you have recognized, to provide tax relief, Madam Chair, to poor working families by increasing the personal exemption. While the personal exemption is the primary tax provision that differentiates tax burden by family size, and raising it would certainly assist low-income families, raising it would also assist every other taxpayer regardless of need and the resulting cost would be very large.

Increasing the personal exemption from $1,000 to $1,800 has been estimated to cost over $30 billion a year. Much of this assistance would be directed to higher income taxpayers. Thus, an increase in the personal exemption, in our view, is a less efficient method for relieving the current tax burden on poor families than those that we are proposing in the children's survival bill. Conversion of the exemption to a credit would be one way to target the assistance and make it more equitable.

Among the different plans, and even though we are very pleased that the Bradley-Gephardt Fair Tax Plan, the Kemp-Kasten Fast Tax Plan, and the U.S. Department of Treasury plan all begin with the premise which we share, that working families in poverty should be exempt from Federal taxes, none of these proposals comes close to restoring Jane Doe and other poor working families to their 1979 tax status.

The Bradley-Gephardt plan does reduce or eliminate Federal taxes for some families in poverty, particularly two-parent families. But for most single-parent households, Bradley-Gephardt provides extremely limited tax relief and actually increases the current disparity in the Federal tax burden between those particularly vulnerable parents and two-parent families. Bradley-Gephardt does little to remedy the currently heavy tax burden imposed on large poor families, because it does not increase the dependent exemption for children at all. And finally, because Bradley-Gephardt neither increases nor indexes the earned income tax credit, it does nothing to relieve the growing Social Security tax burden on poverty level families.

The Kemp-Kasten plan would exempt both traditional two-parent and single-parent poor families from Federal income tax and would close some of the tax disparity between them. But, distressingly, the plan changes the EITC in a way that causes an effective combined Federal tax increase for many poor families, by allowing a reduced offset against Social Security. So, as a result, the tax burden would increase for some of these poor families under Kemp-Kasten.

We do, however, applaud Mr. Kemp's focus on the family and hope to work with him to make his plan more beneficial to all families in poverty.

Finally, the Treasury plan provides significant tax relief to many poor working families in poverty and goes further in reducing the disproportionately heavy taxes on single-parent families. But for all families, however, living below or above the poverty line, the Treasury proposals, like the two other major proposals, fails to restore them to their 1979 tax status.

Poor working families have borne the brunt of harsh budget cuts and of harsh Federal tax burdens. We do hope that those who are struggling for self-sufficiency will no longer be penalized by an

unfair tax system. Millions of working poor families, unable to make ends meet, really are depending on the Congress this year. We look forward to whatever action you are able to take.

The authors of the report are here to answer any questions that you may have.

[Prepared statement of Marian Wright Edelman follows:]

PREPARED STATEMENT OF MARIAN WRIGHT EDELMAN, PRESIDENT, CHILDREN'S DEFENSE FUND, WASHINGTON, DC

The Select Committee on Children, Youth and Families has been a critical catalyst in focusing national attention on the needs of children and families. Your hearing today is especially important as federal taxes and tax policy are increasingly the subject of national political and Congressional debate. We must insure that fair and equitable tax treatment of families with children—most importantly working families struggling to survive on poverty level wages—become and remain central to that debate. Poor families with children in this country are in desperate need of tax relief.

Over 35 million Americans—more than 15 percent of the population—live in poverty. Families, especially female-headed families, make up a large proportion of the poverty population. Nearly half—48.2 percent—of female-headed families with children were poor in 1982, and the majority of children living in poverty in this country are part of female-headed families. Nearly half of all poor single mothers with children attempt to support their families with their own wages, and three-quarters of all other poor families have income from earnings, thus subject to federal taxation.

We all know there are many myths surrounding the poor in this country. One is that the poor pay little or no taxes. This is now grossly incorrect. Individuals and families with incomes below, or equal to, or a little above the official poverty line are paying significant and increasing shares of their meager incomes in taxes. Despite the massive tax cut passed in 1981, the aggregate federal taxes paid by poor families increased 58 percent from 1980 to 1982. In 1982, about half of all individuals and families living in poverty paid federal taxes. Taxes on the working poor have skyrocketed while taxes on the well-to-do and on profitable corporations have declined drastically.

The Children's Defense Fund has just published "The Impact of Federal Taxes on Poor Families," which you have before you. As indicated in our report, the federal tax burden on low income individuals and families has increased dramatically in the last few years. Between 1980 and 1982, for example, the number of persons in poverty paying federal income tax more than doubled. The increasing tax burden on the poor, especially those families headed by women, has coincided with the harsh budget cuts imposed on vital programs serving the very same group. By simultaneously decreasing the tax burden on the wealthy, the federal government's spending and tax policies have thus exacerbated a large and widening gap between the rich and the poor in this country. Furthermore, the high taxes on the near poor drag the real disposable incomes of millions of children and their families from above the poverty line to below it.

It is estimated that most low income working families earning poverty level wages will pay approximately 9 percent to 12 percent of their income in federal Social Security and income taxes in 1984. For example, page 18 of our report shows that a family of four (two parents and two children) with earned income at the 1984 estimated poverty line of $10,613 paid $1,076 in combined federal income and Social Security taxes, or 10.1 percent of its income. Only five years ago, this same family with earnings at the 1979 poverty line paid less than 2 percent of its income in federal taxes (all of it Social Security). The family's combined federal tax burden as a percentage of income more than quintupled during this period.

Single parents—primarily women—struggling to support their children on poverty level wages bear an even heavier federal tax burden than two parent families in poverty. As indicated by the chart on page 19, a single parent family of four with poverty level wages paid $1,210 in 1984—$134 more than the two-parent family. Large poor families also disproportionately suffer from the federal tax system.

Increasing taxes on the poor and near poor lessens the money available to families for supporting children, particularly young children. Americans' incomes normally start low when they are young workers, increase with age, and then drop again in old age. The elderly, however, have special rules giving them extra tax breaks. Substantially raising the taxes of the poor and near poor thus primarily in-

creases the taxes of younger workers, those most likely to have young children and less income to support them. In this respect the tax policy of the last four years has virtually been a tax on childhood—an anti-family tax policy that mirrors the budget cuts which have also disproportionately hurt children.

Contrast the increasing tax burden on poor families with children with the shrinking federal tax on wealthy corporations and individuals. The corporate share of federal revenues fell by half from 12.4 percent in 1980 to 6.2 percent in 1983. Of 250 of the largest and most profitable corporations in America, Citizens for Tax Justice found that in the first three years of Ronald Reagan's administration, over half paid no federal taxes or worse received a refund from the federal government, in at least one of the three years, while earning profits of $57.1 billion. A working single mother with three children, earning $10,500 a year, paid more in federal taxes than Boeing, General Electric, Dupont, Texaco, Mobile and AT & T combined paid in federal income taxes in 1983, although these corporations alone earned $13.7 billion in profits.

We must ask how this happened when Congress passed the largest income tax cut in history in 1981. The working poor are now paying a larger share of their earnings in income taxes not because of higher tax rates—rates were in fact lowered in 1981—but because a much larger share of their earnings is being taxed. Inflation has driven up the wages on which the poor are taxed without giving them more real dollars in income or a higher standard of living, and without adjustments in the tax system to compensate. As a result, the income tax threshold—the income level at which families begin to pay taxes—which was above the poverty line in the late 1970's, but is now well below the poverty line.

The income tax threshold for poor families is ultimately determined by the personal exemption, the standard deduction (or as it is now called the zero bracket amount) and the Earned Income Tax Credit (EITC). For working families in poverty, and those just above the poverty line, the failure to adjust the personal exemption, the standard deduction or the EITC amounts in 1981 more than offset any positive effect of the cut in income tax rates. As a result, we estimate that generally families earning below 160 percent to 210 percent of the poverty line paid higher effective tax rates in 1984 than in 1979. Moreover, the closer the family's earnings to the poverty line, the larger was the increase in effective rates. The poor and near poor were—once again—the losers in 1981.

The current federal tax system is under attack on many fronts, not only because it produces insufficient revenues to reduce dangerously high budget deficits, but because it is perceived by citizens, tax experts, and policymakers alike as overly complex, economically inefficient, and basically unfair. One of its most glaring inequities is the increasing burden on those least able to pay, those individuals and families who live in poverty or close to the poverty line. This inequity must be remedied, because the growing tax burden is an additional obstacle to such families' struggle to be self-sufficient and meet the needs of their children.

Tax fairness for low-income families can be achieved through numerous strategies. Several major tax reform proposals attempt to remedy this basic inequity, at least in part, as one element of a thorough overhaul of the entire federal tax system. Tax fairness for families in poverty can also be achieved, however, through adjustments to the current system even if there is no sweeping overhaul of the tax laws. Congress has a responsibility to undertake such adjustments for the poor. To do so is neither difficult, nor costly. Fairness and equity simply demand an immediate and sharp reduction in the federal tax burden on taxpayers struggling to support their families on low wages.

Improvements in some or all of those tax provisions affecting families in poverty—the personal exemption, the standard deduction, and the EITCF—can substantially benefit low income working families. The Children's Survival Bill, CDF's ominibus legislative agenda for children and families about to be introduced by Chairman Miller, sets out a tax agenda for the working poor by including several proposals essential for tax relief and fairness for those least able to pay. I will summarize our proposals here, and hope we can discuss them with you further in the weeks ahead.

First and foremost, we recommend that the Earned Income Tax Credit (EITC), the one tax provision exclusively available to poor working families with children, be significantly expanded. Developed in 1975 as a work incentive for poor families, the EITC is a refundable credit. It may be utilized to exempt low income working families from federl income taxes, and it can offset the heavily regressive Social Security tax as well. Our proposal seeks to expand eligibility for the EITC of families earning up to $16,000 per year, and to increase the credit itself on a sliding scale to a maximum of $800. This proposal would provide much needed tax relief to working fami-

lies in poverty—exempting most of these families from federal income taxes, and for many offsetting a portion of Social Security taxes.

Second, the EITC must be indexed for inflation. The EITC is the only major tax provision affecting rates that is not scheduled for indexing this year, despite the fact that the value of the EITC has eroded substantially in recent years. Unless the EITC is indexed, federal taxes on the poorest working families will continue to increase in future years. Therefore, any fair and equitable tax proposal must include an expanded and indexed EITC.

Third, the EITC curently depends only on income, and is unrelated to family size—an eligible family of five receives the same credit as an eligible family of three. We thus recommend increasing the EITC with an allowance for each dependent child, and an additional amount for each child under six. This would help large poor families as well as families with young children with child care costs.

Fourth, the standard deduction should be increased. In 1984, as in 1979, the standard deduction was $2,300 for single persons, and families with single heads of households, and $3,400 for married couple families. It is scheduled for indexing in 1985.

Expanding the standard deduction would primarily benefit low income taxpayers and the many moderate income taxpayers who similarly do not itemize deductions.

Fifth, we join with many others in proposing that the standard deduction be adjusted for heads of households. Head of household is a tax term encompassing most single parents and other single taxpayers with dependents. In 1982, 8.4 million taxpayers filed as heads of households. A $3,400 standard deduction is allowed for married couples filing jointly, yet only a $2,300 standard deduction is allowed for single heads of households. As a result of this differential, poor single parents usually pay higher federal taxes than married couples filing jointly with the same income and family size. This structure unfairly penalizes single working parents, many of them women already suffering from disproportionately low wages and the added expenses of child care. Adjusting the standard deduction for heads of households to equal the amount allowed for married couples would remedy this inequity and provide tax relief to an important segment of our working poor population.

Finally, we propose that the Dependent Care Tax Credit be expanded and made refundable. As you know, the dependent care credit is an important element of federal support for child care, and expanding the credit would offer increased assistance to many working families in need. Making the credit refundable would insure that lower income families could take full advantage of the credit.

It is possible to provide tax relief to poor working families by increasing the personal exemption as proposed by Representative Schroeder and others. While the personal exemption is the primary tax provision that differentiates tax burden by family size, and raising it would certainly assist low income families, raising it would also assist other every other taxpayer regardless of need and the resulting cost would be very large. Increasing the personal exemption from $1,000 to $1,800 has been estimated to cost over $30 billion a year, and much of this assistance would be directed to higher income taxpayers. Thus an increase in the personal exemption is a less efficient method for relieving the current tax burden on low income families than those proposed above. Conversion of the exemption to a credit would be one way to target the assistance and make it more equitable.

"The Impact of Federal Taxes on Poor Families" contains a detailed analysis of the major tax reform proposals from the perspectives of low income working families, and I would invite you to review our report very carefully in that regard. It is important to recognize that each of the major tax reform proposals—the Bradley Gephardt FAIR TAX PLAN, the Kemp-Kasten FAST TAX PLAN, the U.S. Department of Treasury plan—begin with the premise, which we share, that working families in poverty should be exempt from federal taxes. While each of the proposals make some progress in relieving the tax burden on the poor, it is unfortunate that none of them comes close to restoring these families to their 1979 tax status (Charts on pages 35–39 compare the impact of these plans on 10 different poverty families).

The Bradley-Gephardt plan does reduce or eliminate federal income taxes for some families in poverty, particularly two-parent families. For most single parent households, however, Bradley-Gephardt provides extremely limited tax relief, and actually increases the current disparity in the federal tax burden between these particularly vulnerable families and two-parent families. Also Bradley-Gephardt does little to remedy the currently heavy tax burden imposed on large poor families, because it does not increase the dependent exemption for children at all. Finally, because Bradley-Gephardt neither increases nor indexes the EITC, it does nothing to relieve the growing Social Security tax burden on poverty level families.

The Kemp-Kasten plan would exempt both traditional two-parent and single parent poverty level families from federal income taxes and would close much of the

current tax disparity existing between them. But distressingly, the plan changes the EITC in a way that causes an effective combined federal tax increase for many poor families, by allowing a reduced offset against Social Security taxes. A traditional family of four earning three-fourths of the poverty line would see its combined federal income and Social Security taxes increase by over 50 percent under the Kemp-Kasten plan. Even those poor families receiving income tax cuts would typically get smaller reductions under Kemp-Kasten than under the Bradley-Gephardt or Treasury plan simply because of Kemp-Kasten's EITC cutback. We applaud Mr. Kemp's focus on the family, however, and hope to work with him to make his plan beneficial to all families in poverty.

Finally, the Department of Treasury plan provides significant tax relief to many working families in poverty and goes further in reducing the disproportionately heavy taxes on single parent families. But for all families living below, or little above the poverty line. Treasury, like the other proposals, fails to restore them to their 1979 tax status.

None of the major tax reform plans adequately adjust the EITC to compensate for its erosion by inflation since 1979, thus precluding sufficient tax relief to the poor. The Treasury plan does not expand the EITC, although importantly the plan indexes it. On the other hand, Bradley-Gephardt neither increases the EITC nor indexes it, and while indexing it, Kemp-Kasten reduces the EITC for everyone making between $4,615, and $11,000 a year. Expanding and indexing the EITC must be the centerpiece of any fair and equitable reform plan.

Poor working families who have borne the brunt of harsh budget cuts are being increasingly impoverished by our federal tax system as well. Working families struggling for self-sufficiency are being penalized by our unfair tax system. Fairness and equity demands that families in poverty be exempt from federal taxes. Millions of working poor families unable to make ends meet are eagerly awaiting Congressional action.

Mrs. SCHROEDER. Thank you very, very much. As always, your testimony and your facts are exemplary.

Congressman Evans?

Mr. EVANS. Just one question.

Your package that Chairman Miller is going to introduce, has that been costed out to the total impact? You mentioned $3 billion, I think, if you——

Ms. EDELMAN. Yes, we—it's an omnibus bill which deals with restorations of successful programs on the benefit side as well as in some of these tax provisions. The overall cost of the bill is about $14 billion. We also, though, have a title II, which may or may not be introduced, but we offer about $40 billion in alternative savings, which would allow us to pay for that.

On some of the tax provisions, we would estimate a cost of about $3 billion for the EITC reforms that we propose. Indexing it for inflation is included in that cost of $3 billion. To deal with the family size within the EITC and stop the discrimination against large families, we estimate will cost another $470 million. That gets us up to $3.5 billion.

We don't have a cost estimate on the standard deduction issue, because we have not set what level of increase should occur. That is one that we will have to do.

To eliminate the differential between single and two-parent families will cost an estimated $1 billion. So, that gets us up to $4.5 billion on the tax side.

To make the dependent care tax credit refundable would cost, we estimate, about $700 million.

So, I think that the overall known cost of this would be about $5.5 to $6 billion, a little less.

But again I would call your attention to the offered savings. I would just remind the Congress that the administration is propos-

ing a $32 billion increase in the defense budget for this year. This is the fifth consecutive year in a row. This is less than, almost between a third and fourth of what that defense increase is for 1 year alone. So, I think that one needs to weigh off the needs of families against another dramatic increase in the defense budget. And we do point you to a number of corporate loopholes which we think could pay for this.

Mr. EVANS. Have you also looked at it as Professor Schorr did in terms of reduced AFDC costs and things like that that we might save?

Mr. WEILL. We haven't looked at those figures.

Mr. EVANS. If you could, I think that is something that he pointed out that is useful.

Mr. WEILL. One reason, on the AFDC side, that increasing the earned income tax credit would save money currently is because AFDC counts that tax credit dollar for dollar. We have proposed in the same bill, however, that the earned income tax credit money that goes to a family should be exempt from being counted as income in AFDC. For that reason, there wouldn't be an AFDC saving under our bill.

Mr. EVANS. Thank you.

Mrs. SCHROEDER. Thank you.

I think that your point that you made about what is transpiring and how we are allocating resources is very important. I was at a conference where a Third World woman gave a very eloquent speech saying the victims of World War III are already here, they are the children. And they are the children in our country, the superpower countries, as well as the others.

When you look at the trend lines, it is very sobering. I think that is one of the things that came along very clearly as we listened to everybody's testimony about these different areas.

I also truly appreciate your analysis of the different simplification bills that are floating around, because the great fear is that one of those will get on a very fast track without anybody thinking of what the effect would be on families, especially low-income families. And that would not be a good idea.

Has the Treasury been in touch with you at all about their Treasury two? My understanding is there will soon be another Treasury bill. Does anybody know? Do you have any idea how you might relate to that or what that is going to look like?

Ms. BOURDETTE. We met with representatives from the Treasury Department some time ago but have not talked to them recently, so I could not comment on what their new plan might include. Certainly they have stressed in public statements many times their commitment to exempting low income families from the income tax. We hope that will be a primary ingredient of any plan that they would propose. But we don't know.

Ms. EDELMAN. Madam Chairman, I guess I would end just by reaffirming just what a disturbing shift in action priorities we have seen over the last 5 years. I mean, children and poor families have been asked to pay for the new tax rates of wealthy corporations and individuals. They have also been asked to pay for the defense increases. We estimate in this year's budget analysis that, if the current spending trends continue, by 1990 every American is going

to be spending 86 percent more on defense and about 19 percent less on poor children and families. I think it gets to the heart fundamentally: What is this Nation supposed to be about?

I think that we need to begin to try to redefine what we mean by national security in terms of the security of our families and our children who in the long run, I think, are going to be more important than anything else we do now. I think these priorities are the central point of what ought to be debated.

Any new proposals for the budget or taxes should be examined very strongly in light of what they will mean in terms of the direction of the Nation as well as the suffering of families just trying to make do.

Mrs. SCHROEDER. I think middle class families are feeling it, too.

Ms. EDELMAN. Middle class families are feeling it.

Mrs. SCHROEDER. When you see somebody who has worked as a policeman all their life, or whatever, not at an incredibly high salary but nevertheless comfortable, we always thought, middle class salary, and suddenly they find that they can't send their children to the college that they are able to be admitted to, they are able to be admitted to a much classier school than they can afford, I do think it really undercuts their dignity. It undercuts their own self-respect. I think the fact that they can't provide at the level the child is able to produce, is crazy. It's crazy for society to allow that to happen, too.

So, all across the board you have to really answer some tough questions.

Thank you.

Ms. EDELMAN. Thank you.

Mrs. SCHROEDER. With that, I think the hearing is adjourned. Thank you all.

[Whereupon, at 11:05 a.m., the committee was adjourned, subject to the call of the Chair.]

[Material submitted for inclusion for the record follows:]

PREPARED STATEMENT OF ALLAN C. CARLSON, PH.D., EXECUTIVE VICE PRESIDENT, THE ROCKFORD INSTITUTE, ROCKFORD, IL

The Rockford Institute is a non-profit research center located in Rockford, Illinois. This Institute is devoted to studying and articulating the cultural foundations of a free society. One particular focus of our work is examining the role and condition of the family in America.

My own research efforts have focused on the origins, substance, and results of family policy experiments in the Western World, particularly Sweden and the United States. I have testified on these matters before the Senate Subcommittee on Family and Human Services and the U.S. Attorney General's Task Force on Family Violence. Essays of mine on family policy have appeared in books such as "Future 21: Directions for America in the 21st Century" and "The Wealth of Families," as well as many American journals, including *Persuasion at Work* (which I edit), "The Public Interest, Policy Review," and "This World."

It is altogether appropriate that this Committee now turns its attention to the question of tax policy and families. Over the last two and a half decades, events have conspired to transform the Federal tax code into what can be accurately labeled an anti-family instrument, one that uniquely penalizes families with small children.

This was not always the case. During the years of the Truman Administration, Congress reached bipartisan agreement revamping the federal tax code in a manner giving recognition to the importance and special burdens of families with dependent children. For example, Congress introduced the joint return which provided lower rates for the intact, single-income family commonly devoted to the rearing of young

Americans. Congress also raised the personal exemption to $600, a figure that under prevailing wage levels removed the large majority of families with three or more children from significant income tax liability.

Yet by the mid-1960's this supportive income tax system keyed to traditional family life was falling apart. The causes of this change were diverse, and not all directly related to tax policy. Inflation, for example, began steadily to erode the value of the dependent exemption. Moreover, during the 1950's a growing number of married women with small children were entering the paid labor force. This development accelerated after 1965, creating new patterns of child care and uneven, piecemeal policy responses on the Federal level. Political pressures also played a role. Some policymakers started listening to the tales of horror about supposed American "overpopulation." By the early 1970's, "no growth" attitudes were in vogue. The 1972 Report of the President's Commission on Population Growth and the American Future actually declared a quite war against the three-child family and urged the elimination of what they labeled "pronatalist" incentives such as the income tax deduction for dependents.

The consequence of these social and political pressures was a tax system that penalized families in two ways:

(1) The erosion of the real value of the dependent exemption combined with other changes in the tax code—the 1969 reduction in tax rates for "singles," the regular increase in the zero-bracket-amount, and the 1981 reform designed to reduce the "marriage penalty"—to produce a startling result: single persons and married couples with no dependents faced essentially the same average tax rates in 1984 as they did in 1960; however, a family with two children confronted an increase of 43 percent in its average tax rate over the same period, while the couples with four children found a staggering 223 percent increase in its average tax rate. In short, during the quarter century after 1960, the effective income tax burden in the United States had been transferred from the unmarried and from couples rearing children.

(2) The Federal government's child care policy is centered on the Child Care Tax Credit, which allows working taxpayers to credit against taxes owed 20 to 30 percent of the costs of securing day care or another hired child care provider (with a cap of between $960 and $1,440 for two children, depending on income). Adopted in 1976 as a means of "tax simplification," it replaced an existing itemized deduction that had been considered a "business expense."

It is now clear, though, that the use of these two phrases—"tax simplification" and "business expense"—obscured a more fundamental and problematic policy change. Psychological research still shows that the full time parental care of preschool children is superior to even the best day care, except among the most disadvantaged groups. Yet Americans struggling to provide just that kind of care are the ones penalized by the tax code.

This injustice derives from the selective nature of federal subsidization. Two-income families with two preschool children cared for by others not only enjoy the benefits of extra income; they also receive an indirect bonus from the government for so ordering their lives. In contrast, those parents who sacrifice a second income in order to perform the socially desirable role of caring for their own small children receive nothing. Neither do those working couples who go to the pains of scheduling their work for different periods of the day. Indeed, the federal government actually taxes these Americans at a higher net rate. In effect, then, the existing tax laws transfer income from parents who care for their own children to parents who do not.

I do not believe that this is the state of affairs desired by the members of this legislative body. This Congress has the opportunity to correct these negative aspects of the existing tax code. Most Americans now realize that the "overpopulation" scare of fifteen years ago was vastly overblown. "No growth" attitudes no longer command popular allegiance and tax policies that penalize the birth of children should be scrapped. Similarly, it is time to take a comprehensive look at Federal child care policy. At present, about fifty percent of the mothers of preschool children work and are eligible to use the child care credit. Yet another fifty percent do not, choosing instead to care for their own children or juggle schedules with their husbands. Congress should take the opportunity to structure the law so that it gives true choice to parents in the selection of child care.

Policy measures to achieve these goals are:

(1) Immediately double the value of the personal and dependent exemption from $1,000 to $2,000. When the deficit in the federal budget is brought down sufficiently, double that figure again to $4000 or its indexed equivalent. Even at that level, the

exemption would offset a significantly lower percentage of income than it did in 1948.

(2) Abolish the Child Care Tax Credit. The simplest and least costly way to restore choice and fairness in child care policy is to end federal subsidization of nonparental care for the relatively well off. The tax revenue recovered could be used to offset partially that revenue lost through the increase in the nondiscriminatory dependent exemption.

(3) If abolishing the credit is not feasible, fairness could then be restored only by extending the maximum credit to parents who care for their own pre-school children. This benefit should be seen as grateful recognition for the financial sacrifices these parents are making to provide their children with psychologically and socially desirable full-time care.

I appreciate the opportunity to make my views known to this Committee.

PREPARED STATEMENT OF GERALD P. REGIER, CHAIRMAN, COMMITTEE ON TAX FAIRNESS FOR FAMILIES, PRESIDENT, FAMILY RESEARCH COUNCIL OF AMERICA, INC.

Madame Chairman, I want to thank you for the opportunity to submit testimony to you today about tax policy and its effect on the family. I also want to applaud your committee's efforts to focus attention on this important issue. I hope that this hearing will be one of the first steps toward putting the family at the center of the tax reform debate.

I am representing a coalition which was formed several months ago to call for tax reform legislation which would address the needs of America's 60 million families. As the Chairman of this Committee on Fairness for Families, it is a real pleasure for me to share with you our coalition's concerns. The coalition is composed of over 20 groups representing almost 5 million taxpayers.

For many years, families have been overlooked in the public debate on tax reform. While various special interest groups have lobbied effectively for structural changes in the tax code, little attention has been given to the effect on the family of various tax reform efforts.

As a result, families with children have been forced to bear an ever-increasing portion of the federal tax burden while the taxation of single persons and married persons without children has remained fairly constant in rate. In fact, a study conducted by a Treasury Department economist, Eugene Steuerle, indicated that due to the decreasing value of the personal exemption over the last several decades, families with two children have experienced an average real increase in income taxes of 43%. Moreover, the income tax burden for families with four children has jumped 223%.

Steuerle describes the shift in the tax burden in this way:

Perhaps no change in the nation's tax laws have been more significant, yet less recognized, than the shift since the late 1940s in the relative tax burdens of households of different size. For both single and married persons with dependents, the tax burden has grown dramatically relative to households without dependents, whether measured by dollars or by average tax rates . . .

This shift in the tax burden of households of different size came about in subtle ways, without, as far as I can determine, any explicit debate by policy makers about the shift, or even whether it was intended. The shift occurred primarily because of a passive policy toward dependents of taxpayers: personal exemptions were kept relatively constant while income of taxpayers increased substantially.

THE IMPORTANCE OF THE PERSONAL AND DEPENDENT EXEMPTION

The personal and dependent exemption is the primary economic tool which the government uses to assist families in their child-rearing responsibilities. While this basic form of *tax relief* applies to all taxpayers, it is especially important to families with dependent children and elderly because it lowers the adjusted gross income upon which their tax liability is determined. As a result more household funds are available to pay for the expense of caring for the dependents.

However, Federal tax policy has allowed this exemption to become less significant over the last several decades. In 1948, the exemption was worth $600, and the use of it decreased the tax base by 24%, completely removing lower income families from federal taxation. By the early 1980's the exemption had not even doubled, although earnings since 1948 have increased seven times over. As a result, the exemption is now worth a meager $300 in real value to families, and reduces the tax base a mere 8%.

Had the personal and the dependent exemption kept pace with inflation and the rise in average earnings, it would now be $5,600! It isn't It is $1,000.

The declining value of the personal and dependent exemption has placed an increased tax burden on families. Moreover, the greater economic pressure caused by this increased tax burden may very well be the cause of many national problems—including divorce, crime, drug abuse, child abuse and runaway children.

SOCIAL POLICY IMPLICATIONS

The social policy implications of the current tax structure are quite alarming. Essentially, the federal government is encouraging smaller families and fewer children. Although this position may please zealous advocates of zero population growth, it raises many serious long-term possibility. Fewer children today means fewer workers tomorrow. The implications of that situation are quite distressing when one considers the long-term survival of the Social Security system and the need for continued economic growth.

Perhaps the most serious consequence of the current tax structure is that it encourages mothers of preschool children in two-parent families to enter the workforce—often against their preference or better judgment. Even though Dr. Armand Nicholi, a Harvard M.D., has documented the detrimental effects of "parental absence" on young children, the real question is not whether mothers should be in the workforce. The real question is whether tax policy should stack the deck against families so that there are no options.

The practical effect of the decreased value of the dependency exemption is that many families today have no options. Couples who choose to have one parent stay at home with preschool children often do so at great financial sacrifice. Moreover, the taxes they pay on their one income help subsidize the child care tax credits offered to many middle and upper-income dual career households. In fact, 64% of the taxpayers who take advantage of the child care tax credit are above the median household income in the United States.

Thus, social policy in this country has encouraged families to have someone outside the home take care of their children rather than making it possible for families to keep more of their income and take care of their own children. This is not a social policy which strengthens the family unit. Instead it signals a lack of importance placed upon the value and role of parents in the lives of their children.

TAX RELIEF FOR POOR FAMILIES

The increased tax burden on the family has adversely affected poor working families more than any other group. To offer some tax relief to the working poor, the Earned Income Tax Credit (EITC) was enacted in 1975. This in effect provides a way to indirectly refund the employee-employer payroll tax. The EITC was originally a refundable credit of 10 percent of earned income for families with children for the first $4,000 per year of income. It phased out at the rate of 10 percent over the next $4,000 of annual earned income. No credit was available after $8,000 of annual earned income. The law was then amended to what is now current law of 10 percent refundable credit for the first $5,000 in annual earned income for families with children giving a maximum credit of $500. It is then phased out at $10,000.

Unfortunately, this tax credit, like the personal and dependent exemption, has failed to keep pace with inflation. Despite a small increase in the EITC, low-income taxpayers have seen their taxable income increase while the tax credit designed to alleviate their tax burden has shrunk in value.

We therefore believe that the EITC should be increased to the same percentage level as the current combined employee-employer Social Security tax which is approximately 14.5%. After this increase is effected it should be indexed just like the dependency exemption so that parents will be encouraged as a matter of policy in fulfilling their child-rearing responsibilities.

POLICY RECOMMENDATIONS

Through its current tax policies, the federal government encourages you to build a greenhouse, upgrade to solar heat, or buy a mortgaged vacation home; but it does not encourage you to invest in a child. For the most part, the only children whose births we financially encourage and support are those born out of wedlock and into welfare.

Clearly, the federal government has not provided adequate leadership in supporting the value of the family in our society. To address the current financial pressures

which families with children face (and to partially rectify the damage done by several decades of anti-family tax policy), I would make these recommendations:

(1) *Give all families some much-needed tax relief by doubling the personal and dependent exemption to $2,000 at a minimum.*—Some people have argued that increasing the exemption would cause a massive loss of revenue. However, this is not the case. All of the major tax reform proposals which double the personal and dependent exemption are "revenue neutral" and will not produce a revenue shortfall. Furthermore, if the dependency exemption is lowered from the targeted $2,000 in order to keep revenue neutrality, then it will be abundantly clear once again that families with children are again being asked to pay for special interest loopholes. This is absolutely not acceptable.

(2) *Give lower-income families a continued incentive to work and stay off welfare by increasing the earned-income tax credit.*—We should do all we can to allow poor working families to keep more of their income by increasing the EITC. The ceiling should be raised at a minimum from the present $10,000 to $12,000. The cost of this recommendation will be minimal and may actually save federal revenue since it would continue to reduce welfare dependency.

(3) *Preserve tax indexing to prevent a decline in the value of the zero bracket amount, the personal and dependent exemption, and the earned income tax credit.*—The inflationary spiral of the 1970s almost destroyed the value of the personal and dependent deduction as well as the EITC. Even though the Reagan Administration has presently brought inflation under control, we must ensure that the exemption and the credit are not eroded again if in the future inflation should again flare up.

(4) *Lower tax rates to help alleviate the financial pressure on families.*

CONCLUSION

Individual families have a right to be angry at the tax system. In 1960, their taxes produced less than twice as much revenue as the corporate income tax. By 1984, individuals were paying more than five times as much as corporations! The deficit that we face today has not come from too high personal and dependency exemptions, nor from the EITC. It has come from other interests including an insatiable appetite for government spending.

We are not advocating that families come to the federal trough to gorge themselves with special privileges like so many other special interest groups. We are advocating a reversal of discrimination against the family and against children; and reversal of several decades of public tax policy which has not recognized nor supported the family.

Clearly, the time has come for families to be placed at the center of the tax reform debate. I urge you and your colleagues to consider and adopt our proposals so that families in America—and particularly those with children to raise—can be relieved from the financial pressures which can stifle their growth and disrupt their harmony.

Thank you very much for this opportunity.

EXTENSION OF REMARKS OF HON. DAN COATS

In our necessary effort to highlight the need for such tax reforms as increasing the personal exemption and the earned income credit, we should not forget that the most effective way to economically assist American families and their children is to make sure the economy grows so that they have good jobs. We don't want it to appear that the government is somehow the "grantor" of a better life for families. Rather, we believe that the problem is that the government has taxed the American family too much and, in effect, penalized parents for having children by letting the tax code become steadily more unfair to families.

Nevertheless, reduced inflation and interest rates are at least as important to many family's disposable income as is the tax code. In many cases, sound economic growth policies may even effect whether a parent has a job. Therefore, I feel it is important that material on the importance of economic growth and marginal tax rates be included in any discussion of taxation and the family.

The first of these quotations relates to the central importance of jobs to our economy:

"In the American opportunity society, human beings are free to live their lives to the fullest, at every level, limited only by their own effort and capacities, not by the oppressive hand of political power and privilege. The American opportunity society requires a socially responsible market economy. To be sure, this is not the only aspect, or even the most important aspect, because man does not live by bread

alone. But he does not live without it. Material propriety helps free mankind from servitude to external circumstance. It lets him turn his attention to the things which transcend the material. The socially responsible free-market economy is a compassionate form of capitalism, which holds up as the ideal a big heart and a strong hand for others. As Winston Churchill put it, the conservative vision includes "a safety net beneath which none need fall and a ladder upon which all might climb." A truly compassionate society measures human welfare not by how many, but by how few of its citizens need government help. At the heart of the American Dream has always been the hope of new possibilities for ourselves and our children. America has always been the one place on earth where you could climb as high or as far as your efforts and God-given talent could take you. But opportunity means more than individual self-fulfillment; not just good work, but also good works. Work and savings are not just the means of accumulating comforts for yourself. They mean being able to meet your obligations to your family, providing your children with greater hope for a better life, and passing on the fullness of life to others. They mean better homes, and better family life; better schools, and better education; loving your neighborhood, and loving your neighbor. So the problem of jobs is central to a free and compassionate society of equal opportunity."

It is also of critical importance to our economy, and thus to the income of American families, that inflation be kept under control. The second insertion relates to its importance:

"We also need a strong national economy. Inflation—a decline in the value of money—by itself is destructive. High progressivity in tax rates by itself discourages labor and capital from increasing their productive efforts. The combination of the two was horrendous. Even as inflation saps our ability to save for the future, to invest in our futures, it lifts both labor and capital into high progressive tax brackets that smother the incentive to produce.

I believe we need to reduce today's high personal income tax rates, to reduce and index capital gains and estate taxes, to adjust business depreciation for inflation, reduce the corporate tax rate, and reduce the regulatory load on business.

While business incentives are necessary, wages and salaries alone account for roughly 80 percent of our national income. Thus the economic decisions of individuals command four times as much of production as the decisions of corporations. By restoring individual incentives—particularly in the inner city—we dip into our greatest source of increased production for economic growth."

It is important in discussing inflation not to make it a trade-off with unemployment. As Congressman Kemp again points out, low inflation and low unemployment need not be mutually exclusive. Both are of vital importance to American families.

"On the one hand, the conservatives said the way to wring inflation out of the economy is to tax away private purchasing power, and the resulting rise in unemployment was simply the price you paid to stop inflation.

On the other hand, liberal believers in the inflation/unemployment tradeoff said you should increase government spending, and finance it by creating money. But this only redistributes income, it doesn't stimulate real economic growth. The only difference between the two, really, is that conservatives argued for raising direct taxes, and the liberals argued for raising the indirect tax of inflation. Economists like Robert Lekachman are now saying. "The era of growth is over and the era of limits is upon is." It means the whole politics of the country has changed. All problems have become distributional. "We already see it," he says, "in a whole set of divisive tendencies: Black versus Jew, men versus women, and the whole debate over energy policy, which is an argument over distribution. This zero-sum idea has afflicted our national leadership for years: the idea that there are only so many jobs to go around. Only so much energy to go around. A fixed amount of prosperity and a fixed amount of poverty, and the government is supposed to divide them up until their sum equals zero. The economy's demand for the safety net of social services grows, while the economy's ability to support it contracts. Opportunities become greater in special-interest lobbying than for producing. The whole process degenerates into a scramble to see who can get the largest slices of a shrinking pie. And the people at the bottom are hurt most."

Paul Craig Roberts has been perhaps the leading theortician of the so-called "supply side economics." He also effectively makes the point that the economy can grow while inflation declines.

"This is the policy package that became known as Reaganomics. Its controversial feature is its belief that the economy can enjoy a rise in real gross national product while inflation declines. Monetary policy would first stabilize and then gradually reduce inflation, while tax cuts would provide liquidity as well as incentives and prevent the slower money growth from causing a recession. By creating the wrong

incentives and damaging the cash flow of individuals and businesses, the tax system had produced a nation of debt junkies. With the economy strung out on credit, it had to be carefully rehabilitated so as not to produce a liquidity crisis. A decade of taxflation (inflation and rising marginal tax rates) had taken most of the gains in individual incomes, leaving people no recourse but to turn to debt to finance their gains in consumption. Since the interest on debt is tax-deductible, being in debt was the only way for people to get some of their income back from the government and experience a rise in living standards. The only way out of this dilemma is to improve production incentives and the cash flow of individuals and businesses, while graually reducing the rate of money growth."

The last insertion includes comments on marginal tax rates. This concept is central to any economic growth strategy.

"Many people also have the mistaken idea that taxes on personal income have no adverse consequences for business other than reducing the demand for products. They believe that higher tax rates on personal income help business by reducing the federal deficit and lowering interest rates. In actual fact, higher personal tax rates reduce private-sector saving and drive up both the cost of credit and the cost of labor to firms. When the Treasury examined the effects of the Kennedy tax cuts, it was found that the personal saving rate rose. This implies that the saving rate would fall if tax rates rise, and indeed the saving rate declined as bracket creep pushed savers into higher tax brackets. Higher income tax rates raise labor costs to the firm, thereby undermining the competiveness of its products at home and abroad. The higher the worker's marginal tax rate, the more expensive it is to the firm to protect wages from being eroded by inflation or to give real wage increases. Since additional income is taxes at the worker's highest brackets, the higher the tax rate, the larger the gross wage necessary to correspond to any net wage. This does not mean that deficits are good for the economy. But it does mean that the argument that higher taxes are preferable to higher borrowing is at best unproved."

Policies that don't mesh with economic growth strategies are likely to be of little gain at best. But such choices need not be made. I, along with Congressman Kemp, have long supported tax reform that both is fair to families and promotes economic growth. Both are essential to American families.

PREPARED STATEMENT OF JOSEPH J. MINARIK BEFORE THE SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, APRIL 12, 1984

I appreciate the opportunity to testify before this Subcommittee on the subject of federal tax policy and poverty in the United States. At the outset, I would like to emphasize that opinions expressed in my testimony are my own, and should not be attributed to The Urban Institute, its officers, trustees, or other staff members.

BACKGROUND AND HISTORY

As the background materials for earlier hearings explain, the federal individual income tax has been changed several times to reduce the tax burden on the poor and the near-poor. The reason is quite straightforward: there is a widespread conviction that those whose incomes are near the subsistence level should not be made less well off by the federal income tax. Despite the clear rationale for this approach, it has been challenged on occasion. Some people have argued that every citizen should pay at least some nominal income tax as a part of the responsibility of a member of a democratic society. While this argument has some appeal, it has not carried the day for at least two reasons. First, although poor people may be excluded from the federal income tax, they still may pay other taxes, including the Social Security payroll tax, federal excise taxes, and state and local sales taxes. And second, requiring persons with very low incomes to file and pay federal income taxes would involve substantial compliance and administrative costs to collect very little revenue.

The consensus objective to lift the federal income tax burden from the poor has been pursued in three ways. First, personal exemptions are provided for each taxpayer and dependent; under current law, the exemption is $1,000. The personal exemption has been increased several times, most recently in the Revenue Act of 1978. In the mid-1970s the Congress experimented with an exemption credit to supplement the personal exemption, but the 1978 Act returned to a straightforward exemption.

The combination of an exemption and a credit complicated the law beyond any possible benefit.

The second means of providing low income relief is the standard deduction, or as it is now called, the "zero bracket amount." The standard deduction allowed by the Internal Revenue Code of 1954 was equal to the lesser of 10 percent of income or $1,000, making it very small for low-income taxpayers. The concept was liberalized substantially in the Revenue Act of 1964 through the establishment of a minimum standard deduction, giving even low-income persons significant relief (originally $200 plus $100 for each exemption claimed). Since 1964, the minimum standard deduction was increased and simplified, until in 1977 a fixed dollar zero bracket amount was made available to all taxpayers (currently $3,400 for married couples and $2,000 for other taxpayers). The larger zero bracket amount has the advantage of allowing significant tax relief without requiring taxpayers to bear the paperwork burden of itemizing their deductions. Further, the relief focused on low- and moderate-income taxpayers, because those with higher incomes generally choose to itemize.

The third avenue of low-income relief is the refundable earned income tax credit, enacted in the Tax Reduction Act of 1975. This tax credit is available only to taxpayers with dependent children, and is equal to 10 percent of their labor income up to a ceiling (currently $5,000 of income, for a $500 credit), with the credit gradually phased down as income increases (the credit currently vanishes at $10,000 of income). The earned income credit was justified partially as general low-income relief, and partially as an implicit refund of the Social Security payroll tax liability that even low-income workers must bear. The excess of the earned income credit over tax otherwise due is payable to the taxpayer in cash, and a relatively complex mechanism for distributing the credit to the taxpayers with each paycheck rather than as an end-of-year tax refund has been established.

The net effect of these three provisions has been to remove, or at least to reduce, the tax burden on poor and near-poor families in most recent years. In 1964, even before the introduction of the earned income tax credit and at the very advent of the poverty concept, the first minimum standard deduction substantially cut the tax liability of poor families. In 1975, the earned income credit establishes a new precedent for negative income taxes (to offset positive payroll taxes) on poor families. Subsequent increases in the minimum standard deduction and the earned income credit further reduced this tax burden. There is ample evidence of Congressional awareness of the relationship between these tax system parameters and the official poverty thresholds, and of Congressional intent to remove the poor from the tax rolls whenever possible.

The only exception to this long-term development has been the tax treatment of single people. The earned income credit was denied to single people (and couples without children), and the exemption and standard deduction for single people has never been sufficient to remove those at the poverty threshold from taxation. This path has been chosen because many single taxpayers are in fact young people, including students, who are partially or fully dependent upon others and whose own income understates their true standard of living; and because other low-income taxpayers are elderly and have additional income from Social Security that need not be reported on tax returns. To protect these elderly from excessive taxation, the law grants them an additional personal exemption upon reaching the age of 65.

RECENT DEVELOPMENTS

This strategy of reducing the tax burden on the poor can be negated by inflation. The personal exemption, zero bracket amount and earned income credit are all denominated in nominal dollars. A person who is on the border of taxability, and whose income just keeps up with a rapid inflation, will become taxable and thus bear a tax burden for the first time. Because the bottom bracket tax rates are quite low, this newly borne tax burden will be small in dollar terms; but for those who are living at a subsistence level, where every dollar counts, even such a small burden can weigh heavily. The concern over this issue is largely the result of the rapid inflation that has occurred since the last adjustment of the exemptions, zero brackets, and the earned income credit in 1978.

THE EVIDENCE

Table 1 of this testimony measures the effect of the low income relief provisions, and inflation, on poor and near-poor families over the last twenty years. The table shows the tax paid as a percentage of income by hypothetical husband-wife families with two children and all of their income from the earnings of one spouse. For comparability over the years, income is denominated in units of 80 percent to 150 percent of the appropriate poverty threshold for each year.

The first two years presented are 1963 (the last tax year before the Kennedy-Johnson tax cut) and 1965 (the first year in which that tax cut was fully effective). The table shows that the establishment of the minimum standard deduction, in combination with reduced tax rates, significantly reduced the tax burden on the poor and near-poor. Of course, the earned income credit was not yet part of the code, and so taxes were never reduced below zero.

TABLE 1.—TAX BURDENS ON POOR AND NEAR-POOR, HUSBAND-WIFE FAMILIES OF FOUR—SELECTED YEARS

Year	Income as a percentage of poverty threshold							
	80	90	100	110	120	130	140	150
1963	0	0.82	2.54	3.94	5.11	6.10	6.95	7.69
1965	0	0	0.87	2.06	3.06	3.94	4.73	5.41
1975	−8.33	−6.29	−4.66	−2.74	−0.43	1.56	3.30	4.62
1980	−6.20	−3.90	−0.86	1.62	3.77	4.71	5.53	6.36
1984	−0.97	1.75	3.38	4.16	4.98	5.68	6.27	6.79

Source: Computed by the author. Assumes a nonfarm family of four with husband and wife under age 65 and two children under age 18, with all income earned as wages by one spouse, and tax returns claiming the standard deduction or zero bracket amount.

The earned income credit was introduced in 1975 along with further increases in the minimum standard deduction (plus an exemption credit to supplement the personal exemption). With these tax provisions, even families with incomes 20 percent above the poverty line paid net negative income taxes, and those further up the income scale had their liabilities substantially reduced.

The year 1975 proved to be the high water mark of progress against tax burdens on the poor. By 1980, the last year before the 1981 tax cuts took effect, the borderline-poor family's net negative income tax has just about disappeared, and taxes over the entire range shown in the table were higher than in 1975, because of the cumulative 53 percent inflation over those years.

The 1981 tax cuts are now fully phased in. They provide lower tax rates at all taxable income levels, but did not increase the personal exemptions, the zero bracket amounts, or the earned income tax credit. Of course, it is these provisions that protect the poor from taxation; the tax rate cuts merely moderate the burden once the poor are inflated onto the tax rolls. The table documents the failure of the 1981 law to deal with this issue. Families at 90 percent of the poverty level are paying income taxes for the first time in ten years. Taxes all up and down the scale are higher than they were in 1980. In fact, apart from the very low income levels where negative taxes are still paid, the poor and near-poor now pay larger fractions of their income in tax than they paid in 1965, immediately after the Kennedy tax cuts. Indeed, from 90 to 110 percent of the poverty line, effective tax rates are now higher than they were in 1963, before the Kennedy tax cuts.

Table 2 presents analogous computations for a single-female-parent family of three. The result is similar. Taxes in recent years have been lower for single-parent families near the poverty line, simply because their poverty line is lower, and therefore closer to the level where the earned income credit is at its maximum. Tax burdens on poor female-headed families were at their lowest in 1975, increased through 1980, and were not reduced by the 1981 cuts. By 1984 female-headed families of three at the poverty line paid income taxes for the first time since 1974; from the poverty level on up the tax burdens exceed those of the post-Kennedy tax cut year of 1965.

TABLE 2.—TAX BURDENS ON POOR AND NEAR-POOR, FEMALE-HEADED FAMILIES OF THREE—SELECTED YEARS

Year	Income as a percentage of poverty threshold							
	80	90	100	110	120	130	140	150
1963	0	1.67	3.31	4.64	5.76	6.70	7.50	8.20
1965	0	0	1.25	2.41	3.37	4.19	5.02	5.76
1975	−10.00	−10.00	−8.57	−6.16	−3.53	−1.25	0.75	2.57
1980	−9.48	−6.93	−3.71	−0.96	1.46	3.54	5.32	6.94

TABLE 2.—TAX BURDENS ON POOR AND NEAR-POOR, FEMALE-HEADED FAMILIES OF THREE—SELECTED YEARS—Continued

Year	Income as a percentage of poverty threshold							
	80	90	100	110	120	130	140	150
1984	−4.03	−0.96	1.59	3.67	5.50	6.17	6.73	7.40

Source: Computed by the author. Assumes a nonfarm female-headed family of three with head under 65 and two children under age 18, withall income earned as wages, and tax returns claiming the standard deduction or zero bracket amount.

Table 3 shows the same computations for a single male. Although the level of taxes that single people must pay is higher, in large part because of ineligibility for the earned income credit, the pattern of changes over time is for the most part similar to that for families. There is more evidence of increasing tax relief for single people over the long haul, however, largely because the minimum standard deduction has increased more in percentage terms for poor and near-poor single persons than it has for families.

TABLE 3.—TAX BURDENS ON POOR AND NEAR-POOR, SINGLE PERSONS—SELECTED YEARS

Year	Income as a percentage of poverty threshold							
	80	90	100	110	120	130	140	150
1963	8.91	9.92	10.73	11.39	11.94	12.41	12.81	13.15
1965	4.74	5.86	6.77	7.52	8.21	8.81	9.32	9.83
1975	0	0.25	1.65	2.86	3.91	4.84	5.69	6.45
1980	1.00	2.45	3.62	4.75	5.86	6.61	7.42	8.13
1984	2.93	3.94	4.82	5.65	6.35	6.94	7.49	7.99

Source: Computed by the author. Assumes a nonfarm single male under age 65, with all income earned as wages, and tax returns claiming the standard deduction or zero bracket amount.

HISTORICAL CONCLUSIONS

The evidence suggests that the erosion of low-income relief has been serious; it has set tax policy back nearly twenty years. Further, that erosion has occurred across the board, affecting all types of low income taxpayers.

The data also show a clear contrast between the distributional effects of the Kennedy tax cuts and the tax cuts of 1981. The Kennedy tax cuts reduced the tax burden on the poor and near-poor; the 1981 tax cuts passively allowed that burden increase. These data are easily verified with reference to the policy steps in the two tax laws. The Kennedy law coupled rate reductions with the establishment of the minimum standard deduction, which favored low-income taxpayers; the 1981 law joined rate cuts with other provisions that favored the more well-off, such as the expansion of IRA accounts, the deduction for two-earner couples, and the forthcoming exclusion for net interest income. While the 1981 tax cuts were approximately proportional by income group, estimates made by the Joint Committee on Internal Revenue Taxation in 1964 show that the Kennedy tax cuts reduced liabilities by 39.0 percent for taxpayers with under $3,000 of income, 26.9 percent for those with $3,000 to $5,000 of income, and 20.6 percent for the $5,000 to $10,000 income group, in contrast to the average for the population as a whole at 19.4 percent.

POLICY CONCLUSIONS

Again, it is evident that the 1981 tax cuts failed to preserve the low income relief in the tax system. This failure occurred on all three fronts: the personal exemptions, the zero bracket amounts, and the earned income credit. Of the three, the earned income credit seems to have received the most attention. Nonetheless, the zero bracket amount and the exemptions cannot be ignored, especially because the earned income credit does not benefit childless couples or single persons.

The 1981 act indexes the personal exemptions and zero bracket amounts beginning in calendar year 1985, but such indexation should not be construed as a remedy for the erosion of low income relief shown in the tables. Indexation will provide relief only for future inflation; it will not compensate for the effects of the esti-

mated 60 percent inflation over 1978–84. Further, indexation does not apply to the earned income tax credit.

Though indexation of all low-income relief provisions might be seen as a remedy for future inflation, such a contention requires examination.

Indexation has possible drawbacks in terms of economic stabilization and the control of inflation. What is needed at a minimum, however, is a consciousness of the impact of tax provisions on low income households. The development of such a consciousness is a valuable function that these hearings can perform.

GENERAL CONCLUSIONS

While the evidence suggests several targeted policy steps to reduce the tax burden on the poor, it also supports a new approach to overall income tax design. I would like to ask the Subcommittee's indulgence to raise this question for just a moment.

A familiar concept in anti-poverty cash transfer programs is target efficiency: the degree to which a program concentrates its benefits on those who must need help. While this term is seldom used in tax policy, there is no reason why it shouldn't be. In fact, in the current context, it could prove quite useful.

There are several provisions of the current income tax that are designed to provide relief to low- or moderate-income taxpayers, but whose overall effect can be quite different. One example mentioned earlier is the additional exemption for elderly taxpayers. As was noted, the additional exemption can be seen as relief for single elderly persons whose exemptions and zero bracket amounts are too low to exempt a povety-level income. With a steeply graduated rate schedule, however, the additional exemption can have quite different effects. In 1981, the latest year for which data are available, there were 5,286 tax returns with at least $1 million of adjusted gross income; of these, 1,815 (34.3 percent) claimed at least one additional exemption for age. In all, 2,659 additional exemptions were claimed on these returns. In effect, the federal government ran a $1,329,500 program of direct cash grants to elderly millionaires. Yet few people were aware that such a program existed, or would even know where to look for it.

Another example of such misdirection in policy is the provision of low-income relief to single people in general. As was noted earlier, the exemptions and zero bracket amounts do not protect many poor single persons from income taxation because of a fear that such relief would be lost on young people who are in fact dependent on their parents, and whose own income therefore understates their true standard of living. Under the current tax law, the low income relief and the graduated tax rates can be used by parents who transfer wealth to their children during life to reduce the tax on the income that such wealth generates.

Many would not want to eliminate the extra exemption for the elderly because of its function of reducing the tax burden on the financially vulnerable moderate-income elderly, among other reasons. And we cannot eliminate the low tax rates in the first brackets for single persons just to prevent tax minimization by a few wealthy families. But we could make the additional exemption for the elderly and the graduated rates more target-efficient by simplifying the tax code, eliminating many of preferential legal provisions that provide selective relief to taxpayers of all income levels, and adopting a lower tax rate schedule.

For example, the additional $1,000 exemption for the elderly reduces tax by $110 for those in the lowest tax bracket, but by $500 for those in the highest rate bracket (like the millionaires discussed above). A system that limited exemptions to reducing tax in a 14 percent bottom tax bracket would save all elderly persons $140. This would reduce the overall cost of the extra exemption and target the revenue loss on those most in need. Likewise, a system that cut the spread of tax rates to a 14 to 30 percent range would substantially reduce the reward to taxpayers who now manage to transfer income from family members in the 50 percent bracket to others at the 11 percent rate.

A number of proposals for fundamental tax restructuring have surfaced recently from both Congressional Democrats and Republicans. The Administration has also expressed an interest, with a report from the Treasury due shortly after the November elections. It is worth remembering that such proposals would have a payoff in the tax treatment of the poor, by directing more relief where it is needed most.

SUPPLEMENTAL STATEMENT OF JOSEPH J. MINARIK, SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE

This supplement presents some caveats and additional information regarding the testimony on federal tax policy and poverty.

THE POVERTY MEASURE

The official measure of the poverty threshold was instituted in the early 1960s. It was based on the cost of a nutritionally adequate diet, and increased for the share of the typical family budget devoted to the purchase of food. The poverty threshold was first measured for 1963, and has since been projected forward (and backward to 1959) according to the rate of change in the consumer price index (CPI).

Escalation of the poverty standard by the CPI means that it represents a constant amount of purchasing power over time. Of course, as real incomes increase, the poverty threshold falls behind the average incomes in the economy; so the poverty standard in 1983 was much closer to the average income of the population than it is now. The poverty standard might drift away from typical living standards in the economy over time for other reasons as well. The original poverty standards made no explicit allowance for taxes; because taxes have increased above the 1963 level in some years, the same poverty standard could represent less purchasing power for market goods.

Another issue is the ability of the CPI to represent accurately changes in prices over long periods of time. As consumer market baskets change dramatically, it is difficult to keep the CPI on track. One particular difficulty has been the handling of owner-occupied housing, and especially mortgage interest cost. Some economists would argue that the CPI overstated true inflation in the late 1970s and early 1980s. Though the handling of homeownership costs in the CPI has been revised, any excessive measured inflation from the earlier years remains permanently embedded in the CPI-measured price level.

There is certainly some arbitrariness in the poverty standard, but it would be a mistake to divert these hearings to a dispute over whether the poverty threshold does or does not measure precisely a subsistence a level of income over each of the last twenty years. The poverty threshold series is certainly a nearly constant level of purchasing power, and it is a level that is modest by the standards of any time in the last two decades. If the tax burden on persons near that standard has increased, then there is a strong case that persons of limited means are bearing weightier burdens.

The particular poverty measures used in the tables in this testimony are based on the original poverty thresholds. These thresholds are differentiated according to the sex and age of the family head, the farm or non-farm residence occupied, and the composition of the family among adults and children. More recently, the Census Bureau has issued thresholds differentiated only according to the number and age of adults and children in the family, representing weighted averages of the population with respect to all of the other attributes. This means that the poverty thresholds change not only as the price level changes, but also as the composition of the population changes among male- and female-headed households, and farm and nonfarm residences. For the purposes of this testimony, I believe that the original thresholds, showing the poverty line for a particular kind of household and changing only because of changes in real purchasing power, are more appropriate. Nonetheless, the conclusions should not be altered significantly whichever thresholds are used.

INCOME SOURCES

The hypothetical households in the tables are assumed to receive all of their income from labor. This may or may not be representative of actual households at the same income level. Many low-income households receive some income from public transfer programs, either cash or non-cash, which is not subject to taxation. Obviously, if some of a household's income is not subject to tax, it is better off. Other households with similar incomes are composed of elderly members; such households would receive some of their income as nontaxable Social Security benefits, but likely also some taxable interest or dividend income that does not qualify for the earned income credit. Thus, real-world households could be either better or worse off than the example households with similar incomes.

The most important point, however, is not to be too picky about the inevitable differences between example households and some households in the infinitely diverse real world. The point is that any real world family supported by a near-minimum-wage job would face the rising tax burdens described in the tables. This eventuality should be a consideration in the making of tax policy, even if some families with similar incomes would not be so taxed.

THE EARNED INCOME TAX CREDIT

The earned income tax credit (EITC) is an important factor in the tax outcomes described in the body of this testimony, and is also one of the least known and understood provisions of the tax code.

This very lack of awareness and understanding is a limitation on the effectiveness of the EITC. It can delay or possibly even prevent the delivery of low-income relief to taxpayers. Employers who are not aware of the existence of the credit, or who are unwilling or unable to deal with the complication, might not use the available procedures to deliver the credit to low-income workers as reductions in their withholding. Without this step, the worker must wait for his credit as an end-of-year tax refund, making it a less than fully effective vehicle for income security. If the taxpayer himself is unaware of or does not understand the credit, he might not claim it on his tax return, meaning that he must wait until the IRS discovers the omission. In some cases, people who deserve the credit might fall through the cracks and not receive it at all; this could be true of workers whose wages are so low that no tax is withheld, meaning that they would not need to file to claim a refund. There are still other drawbacks to the credit; it does not cover many needy persons who do not have dependent children, and it adds to marginal tax rates in the income range over which it is phased out.

Nonetheless, the EITC performs the important function of shielding some low-income woekrs from a rising payroll tax burden. It may not be ideal income security or tax policy, but it stands alone in that particular role.

OTHER TAXES

This statement dealt with the effect of federal income taxes on the poor and near-poor. Of course, these people pay other taxes as well. Just how one views these tax burdens depends on broader issues regarding the concepts of poverty and long-term income security.

As was noted above, the official poverty standards do not explicitly account for any taxes. But they do implicity account for some taxes. Because the original poverty thresholds are escalated from the base year of 1963 by the rate of increase of the CPI, and becasue the CPI measures prices including sales and excise taxes, the poverty thresholds in effect allow for the purpose of a constant 1963 market basket including sales and excise tax costs. Thus, if a particular observer is strictly concerned with the 1963 cost of subsistence, changes in sales and excise taxes after 1963 are of no consequence; the only possible issue is whether the 1963 poverty standards were high enough to bear the sales tax burden imposed at that time. If the perspective is somewhat different, and all sales and excise taxes are considered to be unfair burdens for anyone near the subsistence level, then changes in those taxes are relevant; but from that point of view, the poverty standard is mismeasured because it exceeds the net of tax cost of the 1963 subsistence market basket.

For the record, the Advisory Commission on Intergovernmental Relations reports 31 increases of state sales taxes over the 1981–83 period (counting each increase for several states that raised their sales taxes more than once), as opposed to 28 increases of state income taxes. The most recent data have not yet captured all of these legislative developments, but over the last several years state income tax revenues have increased faster than state sales tax revenues. This result is probably caused by inflation-induced "bracket creep" at the state level, while retail sales were held down by the sluggish economy.

A tax that can bear substantially on poor households, and that is not accounted for in any fashion by the poverty standards, is the Social Security payroll tax. Over the period covered in the tables in the body of this testimony, the employee's share of the payroll tax increased from 3.625 percent to 6.7 percent. The potential impact of this change is obviously large; the attached table shows the effect for families of four, assuming, as in the text, that all income comes from wages.

Exactly how one views this development depends on his perspective of the Social Security system as a whole. The payroll tax takes cash out of the pockets of the poor and near-poor today, and by definition such persons are near subsistence. But on the other hand, the Social Security taxes buy the right to future benefits, and those benefits are not only calculated to give low-wage workers a higher-than-average real rate of return, but they also buy a higher level of return than they did at the beginning of the period. So the Social Security tax can be either a favored form of saving or a current cash drain, depending on one's perspective; the choice may depend heavily on the exact calibration of the earned income tax credit.

Distribution of Tax Reduction Under 1964 Act [1]—Personal Income Taxes

Gross Income (thousands of dollars):	*Percent* [2]
0 to 3	−39.0
3 to 5	−26.9
5 to 10	−20.6
10 to 20	−17.0
20 to 50	−15.5
50 and over	−13.2
Total	−19.4

[1] Excludes effect of capital gains provisions and repeal of the requirement to reduce the depreciation basis of new property by amount of investment credit.
[2] Changes as a percent of existing tax.

Source: Joint Committee on Internal Revenue Taxation.

Distribution of 1984 Tax Reduction Under 1981 Act [1]—Personal Income Taxes

Expanded income class [2]:	*Percent* [4]
Under $5,000	([3])
$5,000 to $10,000	27.1
$10,000 to $15,000	23.9
$15,000 to $20,000	24.5
$20,000 to $30,000	25.4
$30,000 to $50,000	26.3
$50,000 to $100,000	25.7
$100,000 to $200,000	22.4
Over $200,000	20.9
Total	25.1

[1] Includes only rate reductions and deduction for two-earner couples.
[2] Expanded income equals adjusted gross income pluss excluded capital gains and various tax preference items, less investment interest to the extent of investment income.
[3] Not meaningful because this income class does not have positive tax liability.
[4] Changes as a percent of existing tax.

Source: Joint Committee on Taxation.

INCOME AND PAYROLL TAX BURDENS

	Income as a percent of poverty							
	80	90	100	110	120	130	140	150
1963:								
income	0	0.82	2.54	3.94	5.11	610	6.95	7.69
payroll	3.63	3.63	3.63	3.63	3.63	3.63	3.63	3.63
total	3.63	4.45	6.17	7.57	8.74	9.73	10.58	11.32
1984:								
income	−0.97	1.75	3.38	4.16	4.98	5.68	6.27	6.79
payroll	6.70	6.70	6.70	6.70	6.70	6.70	6.70	6.70
Total	5.73	8.45	10.08	10.86	11.68	12.38	12.97	13.49

POVERTY AND TAX LIMITS

Year	2-parent family of 4	1-parent family of 3	Single person
1963:			
Poverty	$3,104.00	$2,450.00	$1,651.00
Tax limit	2,666.67	2,000.00	666.67
1964:			
Poverty	3,144.62	2,482.06	1,672.61
Tax limit	3,000.00	2,300.00	900.00
1965:			
Poverty	3,198.78	2,524.81	1,701.41

POVERTY AND TAX LIMITS—Continued[1]

Year	2-parent family of 4	1-parent family of 3	Single person
Tax limit	3,000.00	2,300.00	900.00
1966:			
Poverty	3,290.17	2,596.95	1,750.02
Tax limit	3,000.00	2,300.00	900.00
1967:			
Poverty	3,384.95	2,671.76	1,800.44
Tax limit	3,000.00	2,300.00	900.00
1968:			
Poverty	3,527.12	2,783.97	1,876.05
Tax limit	3,000.00	2,300.00	900.00
1969:			
Poverty	3,716.68	2,933.59	1,976.88
Tax limit	3,000.00	2,300.00	900.00
1970:			
Poverty	3,936.70	3,107.25	2,093.91
Tax limit	3,600.00	2,975.00	1,725.00
1971:			
Poverty	4,105.95	3,240.84	2,183.93
Tax limit	3,750.00	3,075.00	1,725.00
1972:			
Poverty	4,241.34	3,347.71	2,255.95
Tax limit	4,300.00	3,550.00	2,050.00
1973:			
Poverty	4,505.37	3,556.11	2,396.38
Tax limit	4,300.00	3,550.00	2,050.00
1974:			
Poverty	4,999.57	3,946.18	2,659.24
Tax limit	4,300.00	3,550.00	2,050.00
1975:			
Poverty	5,456.54	4,306.87	2,902.30
Tax limit	6,660.00	5,870.00	2,564.29
1976:			
Poverty	5,771.34	4,555.34	3,069.74
Tax limit	6,860.00	5,986.00	2,700.00
1977:			
Poverty	6,143.69	4,849.24	3,267.79
Tax limit	7,520.00	6,296.00	3,200.00
1978:			
Poverty	6,614.19	5,220.61	3,518.05
Tax limit	7,520.00	6,296.00	3,200.00
1979:			
Poverty	7,358.88	5,808.40	3,914.15
Tax limit	8,626.00	7,509.00	3,300.00
1980:			
Poverty	8,354.06	6,593.89	4,443.48
Tax limit	8,626.00	7,509.00	3,300.00
1981:			
Poverty	9,220.61	7,277.86	4,904.39
Tax limit	8,635.00	7,523.00	3,300.00
1982:			
Poverty	9,785.89	7,724.05	5,205.06
Tax limit	8,727.00	7,675.00	3,300.00
1983:			
Poverty	10,100.69	7,972.52	5,372.50
Tax limit	8,783.00	7,769.00	3,300.00
1984:			
Poverty	10,544.12	8,322.52	5,608.36
Tax limit	8,783.00	7,785.00	3,300.00

POVERTY LINES AND TAX AMOUNTS; FAMILIES OF 4

	Income as percent of poverty							
	80	90	100	110	120	130	140	150
1963:								
Income	$2,483.20	$2,793.60	$3,104.00	$3,414.40	$3,724.80	$4,035.20	$4,345.60	$4,656.00
Tax	0	22.85	78.72	134.59	190.46	246.34	302.21	358.08
1965:								
Income	2,559.20	2,879.10	3,199.00	3,518.90	3,838.80	4,158.70	4,478.60	4,798.50
Tax	0	0	27.86	72.65	117.43	163.81	211.79	259.78
1975:								
Income	4,365.60	4,911.30	5,457.00	6,002.70	6,548.40	7,094.10	7,639.80	8,185.50
Tax	(363.44)	(308.87)	(254.30)	(164.33)	(27.90)	110.47	252.35	378.54
1980:								
Income	6,683.20	7,518.60	8,354.00	9,189.40	10,024.80	10,860.20	11,695.60	12,531.00
Tax	(414.60)	(293.57)	(72.19)	149.19	377.97	511.63	647.21	797.58
1984:								
Income	8,435.20	9,489.60	10,544.00	11,598.40	12,652.80	13,707.20	14,761.60	15,816.00
Tax	(81.71)	166.08	356.29	482.82	630.41	778.03	925.65	1,073.27

POVERTY LINES AND TAX AMOUNTS; FEMALE-HEADED FAMILIES OF 3

	Income as percent of poverty							
	80	90	100	110	120	130	140	150
1963:								
Income	$1,960.00	$2,205.00	$2,450.00	$2,695.00	$2,940.00	$3,185.00	$3,430.00	$3,675.00
Tax	$0	36.90	81.00	125.10	169.20	213.30	257.40	301.50
1965:								
Income	2,020.00	2,272.50	2,525.00	2,777.50	3,030.00	3,282.50	3,535.00	3,787.50
Tax	0	0	31.50	66.85	102.20	137.55	177.60	218.00
1975:								
Income	3,445.60	3,876.30	4,307.00	4,737.70	5,168.40	5,599.10	6,029.80	6,460.50
Tax	(344.56)	(387.63)	(369.30)	(291.95)	(182.22)	(70.23)	45.34	165.94
1980:								
Income	5,275.20	5,934.60	6,594.00	7,253.40	7,912.80	8,572.20	9,231.60	9,891.00
Tax	(500.00)	(411.16)	(244.59)	(69.85)	115.15	303.08	491.01	686.76
1984:								
Income	6,658.40	7,490.70	8,323.00	9,155.30	9,987.60	10,819.90	11,652.20	12,484.50
Tax	(268.28)	(71.78)	132.14	336.05	549.71	667.79	784.31	924.37

POVERTY LINES AND TAX AMOUNTS; SINGLES

	Income as percent of poverty							
	80	90	100	110	120	130	140	150
1963:								
Income	$1,320.80	$1,485.90	$1,651.00	$1,816.10	$1,981.20	$2,146.30	$2,311.40	$2,476.50
Tax	117.74	147.46	177.18	206.90	236.62	266.33	296.05	325.77
1965:								
Income	1,360.80	1,530.90	1,701.00	1,871.10	2,041.20	2,211.30	2,381.40	2,551.50
Tax	64.51	89.64	115.15	140.67	167.59	194.81	222.02	250.76
1975:								
Income	2,321.60	2,611.80	2,902.00	3,192.20	3,482.40	3,772.60	4,062.80	4,353.60
Tax	0	6.65	47.80	91.33	136.18	182.62	231.18	280.57
1980:								
Income	3,554.40	3,998.70	4,443.00	4,887.30	5,331.60	5,775.90	6,220.20	6,664.50
Tax	35.62	97.82	160.88	231.97	303.06	381.66	461.64	541.61

POVERTY LINES AND TAX AMOUNTS; SINGLES—Continued

	Income as percent of poverty							
	80	90	100	110	120	130	140	150
1984:								
Income	4,486.40	5,047.20	5,608.00	6,168.80	6,729.60	7,290.40	7,851.20	8,412.00
Tax	131.37	198.66	270.12	348.63	427.14	505.66	587.68	671.80

NATIONAL TAX ASSOCIATION-TAX INSTITUTE OF AMERICA (PUBLISHER)

[From the National Tax Journal, Vol. XXXIV No. 2]

INDIVIDUAL INCOME TAXATION, 1947–79**

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ABSTRACT

Changes in the economy interact with the actions of taxpayers and the Congress to produce an individual income tax structure that is itself changing. This paper examines the net effect of these various changes by presenting historical data on aggregate measures of the burden of the individual income tax, including the size of the tax base relative to personal income and the distribution of marginal tax rates faced by taxpayers. Where trends are apparent, they are also noted and discussed in the text.

I. Introduction

SINCE the end of World War II there have been numerous revisions in the laws governing the Federal individual income tax. During the last decade alone, there were at least five major "revenue," "tax reform," or "simplification" acts. Not only has each revision affected the base of the individual income tax through various changes in allowable exclusions exemptions, deductions and credits, but the rate schedules applying to the tax base have been occasionally altered as well. These tax laws have been further modified and interpreted through an expanding set of regulations, rulings, and court decisions.

In addition to legislative, executive, and judicial actions, people have altered the distribution of their earnings between nontaxable and taxable sources, and they have reallocated their expenditures among various excludable (or deductible) and nonexcludable items. These modifications of earning and expenditure patterns not only affect the tax base, but themselves are partly the result of incentives and disincentives written into the Internal Revenue Code.

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Since the schedules of tax rates in the individual income tax laws are progressive, a rise in money incomes because of inflation or real growth in the economy tends to push individuals into higher marginal tax rate brackets and to increase average tax rates as well. However, whether actual rates rise over a given period also depends on legislated tax changes enacted over the same interval.

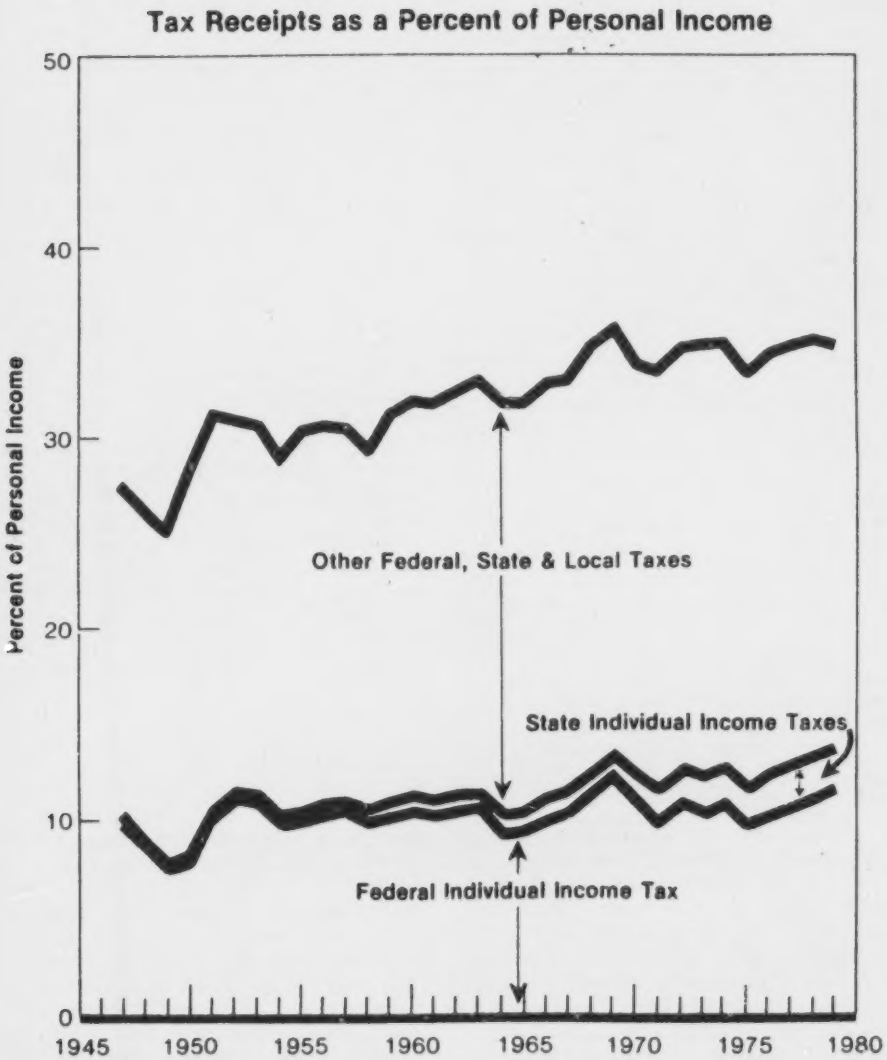
Thus, changes in the economy interact with the actions of taxpayers and the Congress to produce an individual income tax structure that is itself changing. The purpose of this paper is to examine the net effect of these various changes by presenting historical data on aggregate measures of the burden of the individual income tax, including the size of the tax base relative to personal income and the distribution of marginal tax rates faced by taxpayers. Where trends are apparent, they are also noted and discussed in the text.

II. The Individual Income Tax in the Federal System of Taxation

The Federal individual income tax is the largest single source of revenues in the Federal tax system. Since 1947, "effective" tax rates, i.e., Federal individual income tax receipts as a percent of personal income,[1] have varied between 7.4 percent and 12.1 percent (see Figure 1).[2] If the years before 1951 are ignored, the band has been even more narrow, with the effective rate varying between a low of 9.2 percent (in 1964) and a high of 12.1 percent (in 1969). While the range has been limited over these years, the peaks have occurred during the Korean and Vietnam conflicts. However, projections generally show that in 1981 this ratio may rise to a new high.[3]

Federal individual income tax receipts have generally comprised about one-third of total Federal, State and local tax re-

Figure 1



ceipts. Compared to individual income tax receipts, however, total receipts increased more rapidly and steadily from 1947 to 1979. Like individual income tax receipts, total receipts as a percentage of personal income reached a high in 1969. From 1969–1979, the range of total receipts relative to personal income has been quite narrow, varying between a low of 33.1 percent and a high of 36.0 percent.

The composition of total receipts has

changed more dramatically than the amount of these receipts. While the Federal individual income tax remained a fairly constant percentage of personal income, between 1947 and 1979 social security taxes increased from 1.1 percent to 6.6 percent of personal income, while State and local taxes increased from 6.4 percent to 10.9 percent of personal income. These increases more than offset declines over the same period in Federal corporate profits tax (from 5.6 percent to 3.3 percent of personal income) and other Federal taxes, chiefly excises (from 4.7 percent to 1.8 percent of personal income).[4]

Increases in income taxes collected by State and local governments were one reason for the rise in total State and local taxes. These income taxes have comprised an increasingly larger share of personal income and total State and local taxes over the 1947–1979 period. When State and local income taxes are combined with Federal income taxes, a growth trend in individual income tax collections as a percentage of personal income becomes more apparent. Indeed, by 1979, this aggregate measure of income taxes paid by individuals reached 13.6 percent of personal income, just surpassing the previous high reached in 1969.

III. The Tax Base

Average tax rates give a misleading picture of the effect of governmental activity on the use of resources in the economy. Factor incomes "taken" and reallocated by the government are often measured differently depending upon whether a transfer or subsidy is accomplished through direct expenditures or tax reductions. Even if average rates stay constant, changes in exclusions, deductions, credits and marginal rates may cause a reallocation of resources by influencing individuals to engage in tax-preferred activity and by affecting their marginal decisions to work, save and invest. Therefore, it will be useful to look beyond changes in average tax rates to the more specific changes in the income tax base and in the rates of tax that apply to each part of that base.

A. Exclusions from Adjusted Gross Income

Over the last three decades there has been a large growth in the amount of individual income that is not required to be counted as adjusted gross income (AGI). Because these exclusions are not in AGI, they are often not even reported on tax returns. Table 1 presents the major items of personal income for which an exclusion is allowed either by law or by regulation.

The net amount of exclusions reported in this table are generally calculated by subtracting the amount of income from an excluded source reported on tax returns, if any, from the amount of such income included by the Bureau of Economic Analysis (BEA) in personal income.

The BEA treats programs such as social security as pure transfer programs and measures personal income from these sources on the basis of benefits received, but does not include in personal income either employee or employer contributions. The income tax system, on the other hand, counts only employee contributions as subject to income tax, but excludes all benefits and all employer contributions from income taxation. Therefore, to derive the net amount of personal income from social security excluded from income taxation, the taxable payments made by employees must be netted from the nontaxable benefits. In a year in which receipts equal outlays, or benefits equal employer plus employee contributions, this net exclusion is approximately equal to the value of employer contributions which are nontaxable to employees.

On the other hand, both the BEA and Table 1 treat non-taxed employer contributions to private pension and profit-sharing plans, plus interest on pension reserves, as current income to plan participants. The income tax system excludes this income from taxation until actually paid to plan recipients. Therefore, the figure for net non-taxable in-

Table 1

PERSONAL INCOME EXCLUDED FROM ADJUSTED GROSS INCOME a/
(As a Percentage of Personal Income)

Year	Transfers: Net Nontaxable Soc.Sec., Railroad Retirement and Supplemental Med. Insurance: Retirement & Disability	Transfers: Net Nontaxable Soc.Sec., Railroad Retirement and Supplemental Med. Insurance: Health	Transfers: Other Nontaxable Transfers	Net Nontaxable Labor-Related Income: Pension & Profit Sharing	Net Nontaxable Labor-Related Income: Health Insurance	Net Nontaxable Labor-Related Income: Other Labor Compensation	Other Statutory Exclusions	Other Differences (Net)	Total
1947	-.2	-	5.7	.5 b/	.2 b/	.5 b/	1.7	0.7	9.1
1949	-.1	-	5.4	.5	.3	.5	1.3	2.9	10.9
1953	.3	-	3.5	.9	.5	.5	1.3	4.2	10.8
1957	1.0	-	3.6	1.1	.7	.6	1.3	4.0	12.2
1961	1.6	-	4.2	1.1	.9	.7	1.3	4.0	13.7
1965	1.8	-	3.4	1.3	1.1	.7	1.5	3.9	13.6
1969	1.3	.5	3.5	1.3	1.3	.8	1.8	3.0	13.5
1973	2.3	.3	4.3	1.5	1.7	.9	1.6	2.8	15.4
1977	2.9	.8	5.0	1.9	2.2	1.0	1.8	3.1	18.6
1978	2.8	.8	4.6	1.9	2.2	1.1	1.8	3.3	18.4
1979	2.6	.8	4.4	2.1	2.1	1.1	1.8 c/	3.6	18.6

a/ Sources and details in Appendix, Table A-2.

b/ 1947 information not available; percentage assumed to equal that for 1948.

c/ Limited 1979 information available; percentage assumed to equal that for 1978.

come in this case equals current income to plan participants less taxable benefits actually paid to plan recipients.[5]

Public transfer payments have grown significantly since 1947, primarily because of increases in payments for retirement and disability through social security and for health care through social security and supplementary medical insurance. The category, "other nontaxable transfers," which includes unemployment compensation,[6] veterans' benefits, food stamps, etc., has remained more stable in relation to personal income, although there have been changes in the composition of those transfers, e.g., increases in food stamp payments relative to veterans' payments.

Just as payments to public retirement and health plans are the major sources of nontaxable transfer income, payments to private retirement and health plans are the major sources of nontaxable labor-related income. From 1947 to 1979 the net exclusion resulting from the tax treatment of pension, profit-sharing and health plans (primarily the employee exclusion of employer payments to these plans) has risen steadily from .7 percent to 4.2 percent of personal income. By the end of the 1960's the exclusion of health insurance benefits had become as important as the exclusion applying to pension and profit-sharing plans.

The increased tendency of employees to receive labor compensation in the form of fringe benefits is reflected not only in the growth of retirement and health plans. Non-taxable "other labor compensation" (e.g., group life insurance) also demonstrates fairly continuous growth relative to personal income.

"Other statutory exclusions" include tax-exempt interest and most items listed on tax returns as deductions from gross income to adjusted gross income, e.g., moving expenses. On the whole, these other exclusions and deductions show mixed trends since 1947, although there appears to be a slight growth relative to personal income since the late 1950's. Even though new types have been adopted over time, the amount deducted through existing provisions often grew slower than personal income because maximum deduction amounts (e.g., for contributions to individual retirement accounts) remained fixed during extended periods of income growth.[7]

Finally, there appears to have been a fair amount of cyclical movement in the net amount of exclusion resulting from "other differences." This variable includes those exclusions not disucssed thus far, plus several different items which are necessary to reconcile personal income and adjusted gross income. For instance, "other differences" not only includes the exclusion arising from the nontaxation of imputed rental income, but also subtracts income treated as adjusted gross income, but not as personal income (e.g., realized capital gains). Since many items are included in the measure of "other differences," it should be interpreted with caution.

Although different historical trends apply to different exclusions, total exclusions have grown over the last 30 years from about 11 percent to 19 percent of personal income. These exclusions apply to a broad group of individuals; indeed, as workers receiving pension and health benefits or as participants in the social security system, there are few, if any, taxpayers who do not "benefit" from exclusions.

For many taxpayers, however, such benefits may be largely illusory. To the extent that the government raises the same revenue, the elimination of tax on some income means a higher rate of tax on other income.[8] For instance, in 1979 exclusions were about 18.4 percent of personal income. While the average Federal tax rate of personal income was about 11.6 percent, on adjusted gross income the rate was 14.2 percent, or 22.5 percent higher. By the same token, marginal tax rates were higher than they would have been if excludable income had been taxable. These higher marginal tax rates may act not only as a disincentive to the taxpayer to work and save, but, when he works and saves, as a further incentive to obtain income in excludable form. The

Table 2

DEDUCTIONS, EXEMPTIONS, CREDITS AND OTHER NONTAXABLE ADJUSTED GROSS INCOME a/
(As a Percentage of Personal Income)

Year	AGI of Nontaxable Individuals, Non-reported AGI and Reconciliation	Standard Deductions or Zero Bracket Amounts for Non-Itemizers on Taxable Returns	Itemized Deductions on Taxable Returns	Exemptions on Taxable Returns	Income Offset by Credits on Taxable Returns	Total
1947	19.7	4.5	3.7	23.3	.3 b/	51.5
1949	22.0	4.4	3.7	24.3	.3 b/	54.7
1953	16.1	4.5	5.0	24.0	.3 b/	49.8
1957	13.1	3.5	6.8	21.9	.5	45.8
1961	11.8	2.8	8.5	19.8	.5	43.4
1965	10.7	2.9	8.8	17.0	.5	39.9
1969	8.5	2.4	10.1	14.1	.5	35.5
1973	9.5	5.1	9.6	12.4	.7	37.3
1977	9.9	7.3	8.6	8.2	4.7	38.6
1978	9.4	6.7	9.1	7.7	5.2	38.0
1979	9.4 c/	6.5	9.0	9.3	1.5	35.7

a/ Sources and details in Appendix, Table A-3.

b/ Information not available before 1954; percentage assumed to equal that for 1954.

c/ Limited 1979 information available; percentage assumed to equal that for 1978.

effect may build upon itself. As an example, excluding employer payments for medical insurance leads to a higher tax rate on other types of income (revenues being held constant), which in turn provides future incentives for individuals to take more of their income in the form of employer-provided medical insurance. This increase in the demand for such insurance (along with a possible increase in the price of medical care) increases the amount of excludable employer payments for medical insurance, and the process continues.[9]

B. Deductions, Exemptions, Credits and Other Nontaxable Adjusted Gross Income

To determine the percentage of personal income which actually comprises the tax base, it is necessary not only to take into account the amount of exclusions from adjusted gross income, but also other deductions, exemptions, and similar exceptions by which the taxpayer reduces taxable income and tax liabilities.

Unlike exclusions from adjusted gross income, the total value of these other exemptions and deductions have declined relative to personal income over time (see Table 2). One reason for this decline is that, relative to personal income, the adjusted gross income of nontaxable individuals decreased substantially from 1947 to the end of the 1960's and then remained relatively constant during the 1970's. Unfortunately, this amount cannot be measured separately from nonreported income of taxable returns and other differences between BEA and IRS measures of AGI. The combined measure declined from 19.7 percent of personal income in 1947 to about 9.4 percent in 1979.[10] Because incomes of households have grown faster than tax-exempt levels of income (discussed below), the decrease in the relative amount of AGI of nontaxable individuals is explained in part by the simultaneous decrease in the percentage of households with AGI below tax thresholds.

The amount of exemptions and deductions relative to personal income has also decreased since 1947. This shrinkage is due almost entirely to the drastic reduction in the relative value of personal exemptions. On taxable returns, these exemptions have decreased since the early 1950's from over 24 percent to 9.3 percent of personal income.[11]

Standard deductions (or zero bracket amounts for nonitemizers) also fell in relative value during the 1950's and 1960's, but then rose in the 1970's from less than 2 1/2 percent to a high of 7.3 percent in 1977. By 1979, this percentage had dropped to 6.5 because prices and incomes rose faster than the zero bracket amount, which was increased slightly in 1979.

Since 1947 there has also been an increase in the amount of deductions that have been itemized on tax returns. Itemizations grew from 3.7 percent of personal income in 1947 to 10.1 percent in 1969,[12] then declined slightly to 9.0 percent by 1979. Accompanying this decline throughout the early and middle 1970's, however, were the legislated increases in the value of the standard deduction, and a corresponding increase in the number of non-itemizers. Indeed, the decline in itemizations from 1969 to 1979 equaled only 1.1 percent of personal income, while the increase in standard deductions was 4.1 percent.

A final way to reduce individual income tax liability is through the use of credits. By "grossing up" the tax offset by the credit, it is possible to estimate an equivalent amount of income which is made nontaxable. Credits essentially offset taxable income in the lowest brackets first. For example, if a taxpayer has $160 of credits, and if the bracket width is $1,000 for the first two positive rates of 14 percent and 15 percent, then the taxpayer's credits offset $1,000 of income at 14 percent and $133.33 (= $20/.15) at the 15 percent rate.[13]

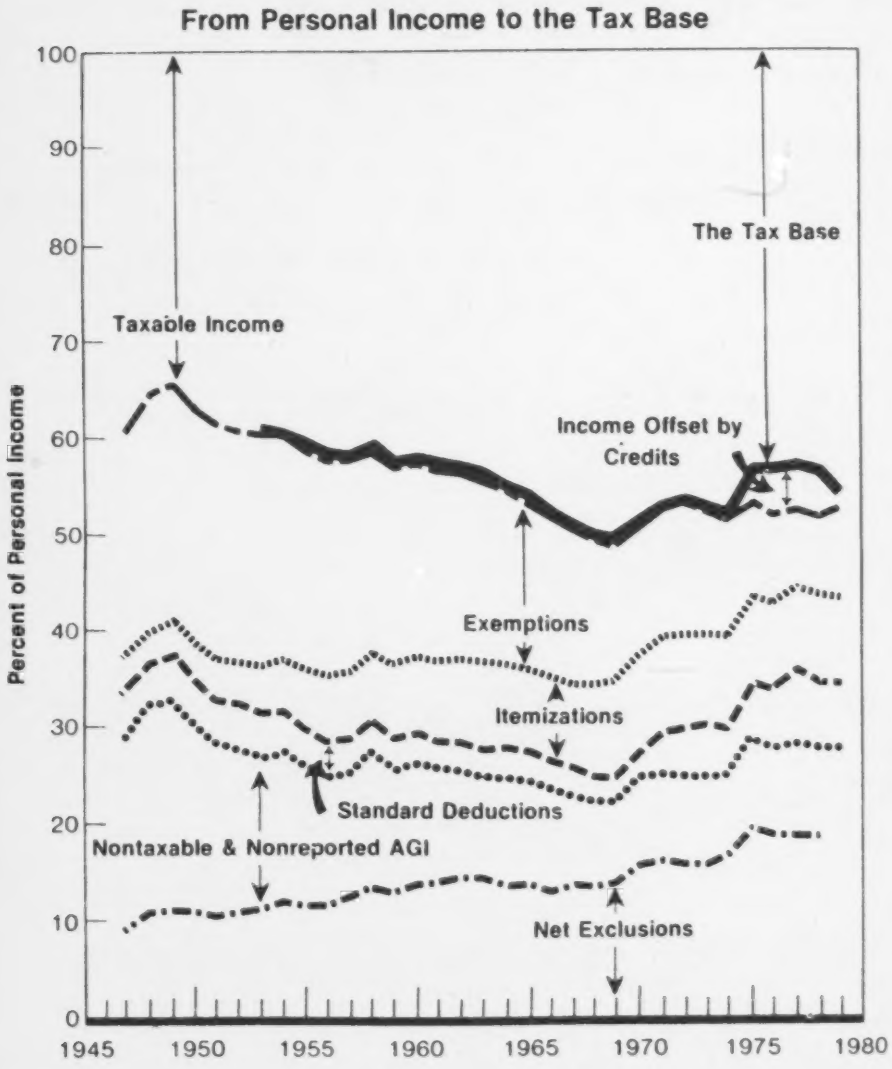
While credits offset only 1.4 percent of personal income in 1979, that percentage was still substantially higher than any percentage that applied before the 1970s. From 1975 to 1978 a general tax credit was provided to taxpayers in a manner

somewhat similar to the personal exemption, that is, it was available to all taxpayers rather than limited to groups of taxpayers with specific characteristics or particular expenditures (e.g., credit for the elderly, child and dependent care credit). Income offset by all credits was at its highest level during that period.

C. Aggregate Reduction in the Tax Base

When the exclusion amounts listed in Table 1 are combined with the amount of deductions, exemptions, etc. detailed in Table 2, they result in 49 percent to 66 percent of personal income being excepted from taxation for each year of the

Figure 2



period, 1947 to 1979 (see Figure 2). Thus, no more than 51 percent of personal income was ever in the tax base in the sense of being taxed at a positive rate. This income taxed at a positive rate (or, excluding income offset by credits, taxable income) actually grew as a percentage of personal income through the 1950's and 1960's, reaching a high in 1969. From 1970 to 1977, there was a decline in the tax base as a percentage of personal income to about the level applicable in the early 1960's, although the trend has been upward again since 1977.

More dramatic than the overall trend has been the combination of factors which produced this movement. For instance, from 1947 to 1979 the tax base increased (or income excepted from taxation decreased) by 6.3 percent of personal income because a decrease of 24.3 percent of personal income principally in the value of personal exemptions and the AGI of nontaxable individuals more than offset an increase of 18.0 percent of personal income in the amount of exclusions, standard deductions, itemizations and credits (see Table 3).

Table 3

AGGREGATE CHANGE IN THE TAX BASE, 1947-79

(As a Percentage of Personal Income)

Increases in Tax Base Due to Decreases In:	
Personal Exemptions	14.0%
AGI of Nontaxable Individuals, Nonreported AGI & Reconciliation	10.3
Total Increase	24.3
Decreases in Tax Base Due to Increases In:	
Net Exclusions from AGI	9.5%
Itemizations	5.3
Standard Deductions	2.1
Income Offset by Credits	1.2
Total Decrease	18.0
Net Increase in Tax Base (or Decrease in Income Excepted from Taxation)	6.3%

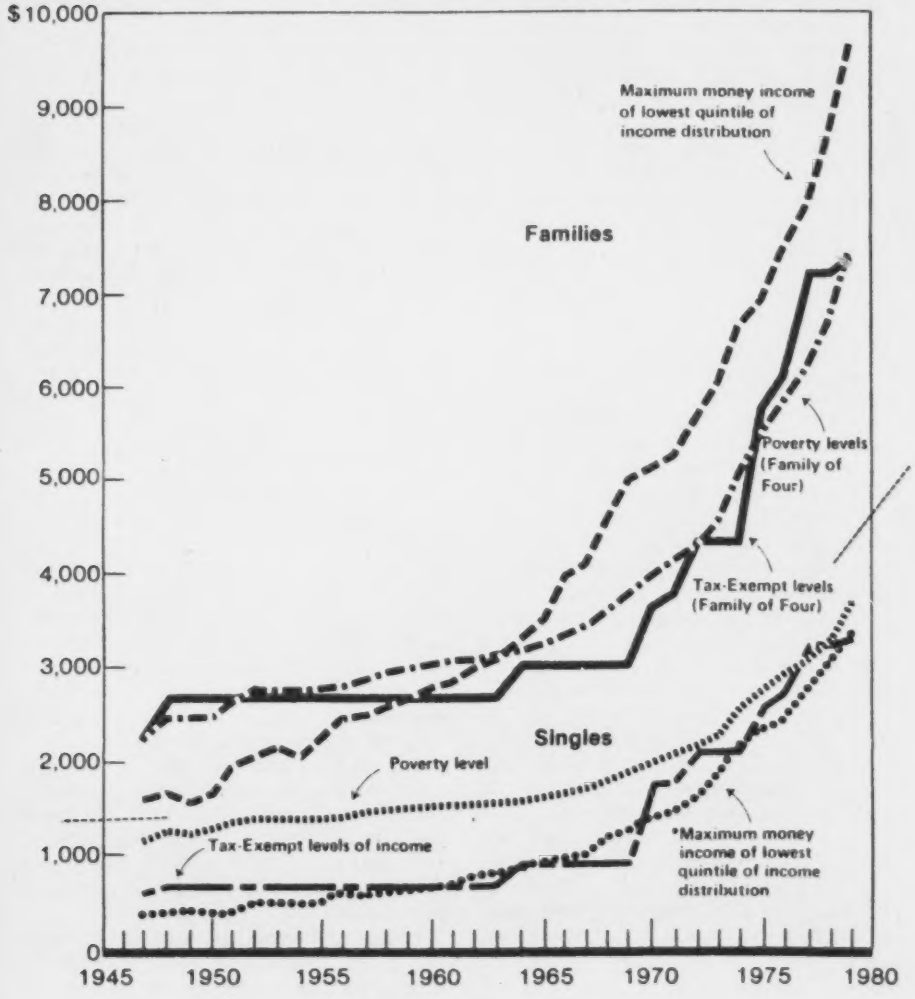
D. Tax-Exempt Levels of Income

Exclusions, deductions, exemptions and credits determine the minimum levels of income for which taxpayers bear any tax liability at all. Since exclusions and most credits are available to only some taxpayers (the general tax credit of 1975–78 being an exception), minimum tax-exempt income levels for most people are determined by the standard deduction (or zero bracket amount), the personal exemption and the general tax credit.[14]

Figure 3 presents data on tax-exempt levels of income for the years, 1947–79, and compares these tax-exempt levels to

Figure 3

Income, Poverty Levels, & Tax-Exempt Levels of Income



income and poverty levels for the same years.[15] Three general trends can be detected. First, tax-exempt levels for families of four have remained fairly close to official poverty levels for the entire period. This is not coincidental, at least since 1964. "Congress has used the standard deduction or (the minimum standard deduction) and the personal exemption to establish a tax-free income level approximating the poverty level. This policy began with the Revenue Act of 1964."[16]

Second, tax-exempt levels have increased at the same rate or at a slightly higher rate than the increase in prices since 1947, but at a rate lower than the rate of increase in incomes. In part, this is a result of the connection made between official poverty levels and tax-exempt levels of income. Official poverty levels are redetermined each year by multiplying the previous year's poverty level by the percentage change in the consumer price index (CPI) between the two years.[17] Yet incomes have increased faster than prices and, therefore, faster than tax-exempt levels of income. For instance, the maximum money income of a family in the lowest quintile of the income distribution (i.e., the income level exceeded by exactly 80 percent of families) grew 512 percent from 1947 to 1979, while tax-exempt levels for families of four increased by only 233 percent over the same period.[18] These data help to explain one of the trends noted previously: the decline in the adjusted gross income of nontaxable individuals as a percentage of personal income.

Finally, there has been a substantial shift in the distribution of benefits arising from the standard deduction and the personal exemption away from families with dependents and toward single persons and couples without dependents. Since 1947, tax-exempt levels have risen 494 percent for single persons, 386 percent for couples without dependents but only 233 percent for couples with two dependents. The percentages are even lower for couples with more than two dependents. This redistribution of benefits arose for two related reasons.

First, in 1964, the minimum standard deduction for a single person was raised above one-half the level for a married couple. Thus, single persons began to receive increases in the standard deduction at a faster rate than that applied to married couples. This structural change emanated in part from the notion, adopted in 1964, that tax-exempt levels should approximate the poverty level. Since the poverty level for a single person was at a higher than one-half the level for a couple, the tax-exempt level for a single person needed to be raised to a level more than one-half that of a couple.[19]

A second cause of the redistribution of benefits toward single people and married couples without dependents has been the reduction in the importance of the personal exemption relative to the standard deduction. Increases in the amounts of standard deduction are the same for couples with and without dependents, while increases in exemption levels are worth more to couples with dependents. Thus, in recent decades tax-exempt levels of income for families without dependents have moved closer and closer to tax-exempt levels for families with dependents.

IV. Tax Rates

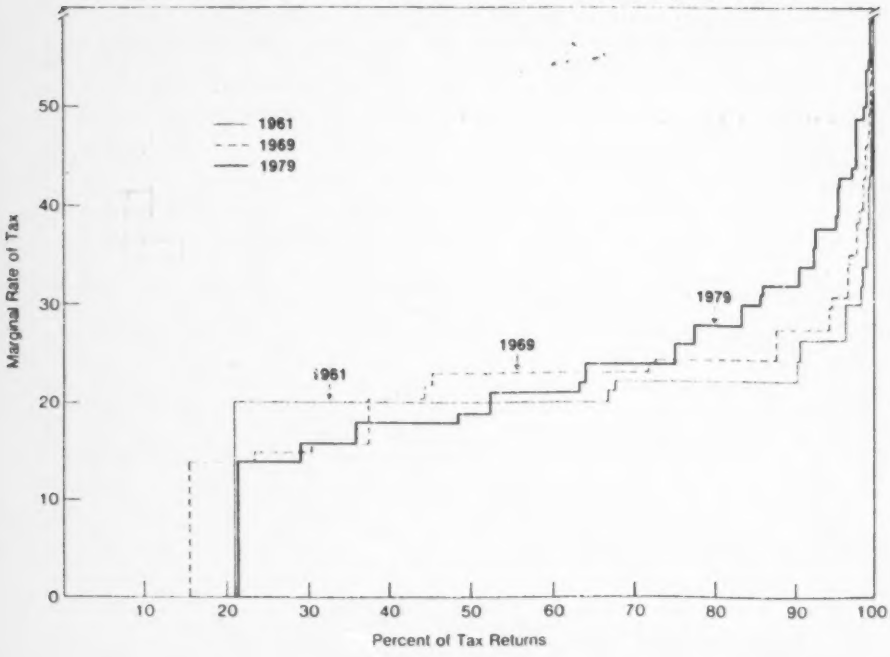
To complete the picture of the changes in the individual income tax over time, it is necessary to examine the changes in the marginal tax rates. Marginal tax rates are those rates which are paid on additional dollars of income. Therefore, to the extent that taxes affect decisions to work more or to save and invest additional dollars of income, it is marginal, not average, rates of tax that are generally considered responsible.[20]

The distribution of returns and personal income by marginal rate of tax is presented in Figures 4 and 5.[21] Marginal tax rate information is not available before 1961. For 1979, the Treasury Tax Model was used to make the necessary calculations.[22]

The structure of tax rates has changed significantly since 1961. In the early 1960's most individuals faced an essentially con-

Figure 4

Cumulative Percent of Returns Taxed at or Below Each Marginal Rate of Tax



stant, rather than progressive, schedule of tax rates. For instance, in 1961 only 10 percent of tax returns had any positive marginal tax rate other than 20–22 percent (see Figure 4). By 1969 the tax rate structure had become much more progressive.[23] Tax rates in the first bracket were lowered from 20 to 14 percent in the Revenue Act of 1964, while at the top end of the scale, growth in incomes began to push individuals into higher marginal rate brackets.[24] By 1979, the effective structure of rates had become more progressive still, with roughly half of all returns at higher marginal tax rates than in 1961 and three-tenths at lower rates (two-tenths remained nontaxable).[25] Some of the greatest differences occurred for tax returns with the highest marginal rates of tax. For instance, for returns at the 95th percentile, the marginal tax rate increased from 26 percent in 1961 to 32 percent in 1969 to 38 percent in 1979.

A slightly different perspective is obtained from Figure 5, which shows the percentage of total personal income (rather than the percentage of returns) taxed at or below various rates of tax. Taxpayers pay tax on their income not only in their highest marginal bracket, but in each lower bracket as well. Because many of the changes in the distribution of personal income by rate of tax resemble changes in the distribution of returns by marginal rate of tax, there is a counterclockwise rotation over time in the curves in both Figures 4 and 5.

Figure 5 provides a quite useful summary of other sections of this paper as well. First, the tax base (determined by the exclusions, deductions, exemptions, etc. discussed in the previous section) is shown in the figure as the percentage of personal income taxed at a positive rate. Second, the average rate of tax on all personal income is equal to the integral, or

area, under each curve. By examining this area, we can understand how marginal rates of tax were able to rise for many individuals between 1969 and 1979 even though the average rate for all persons in 1979 remained below the 1969 high. The revenues gained by taxing some income at higher rates simply did not compensate for the revenues lost by taxing other income at lower rates and the reduction in the tax base over that period.

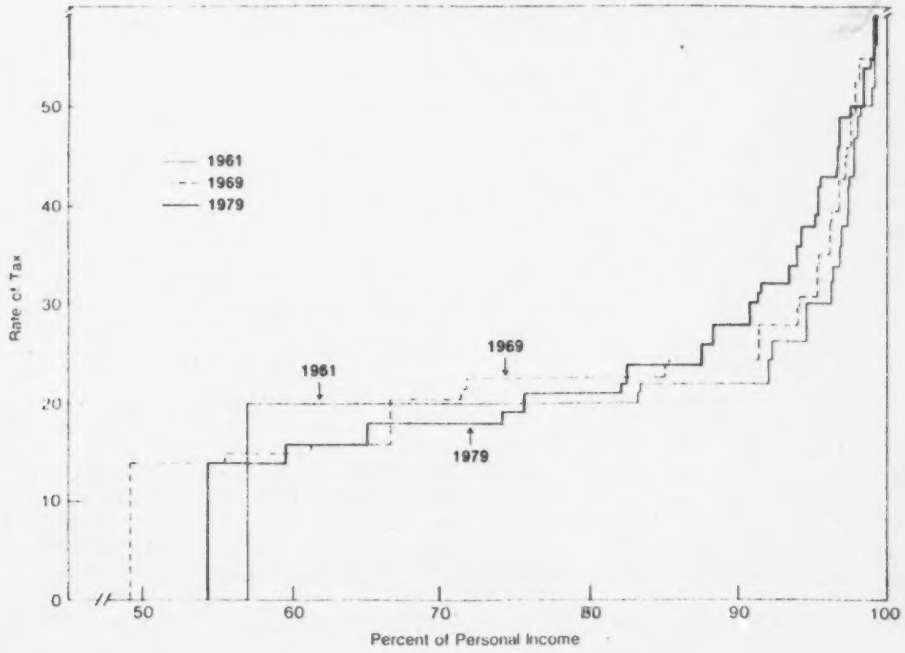
V. Conclusion

Changes in the economy have combined with the actions of Congress, administrators and taxpayers to modify the structure of the individual income tax. Despite the many changes, the average rate of tax has ranged between 9.2 and 12.1 percent of personal income since 1951. For 1981 however, the rate may reach a new high just above 12.1 percent. More significant perhaps than any change in the average rate of taxation has been the shift in the means through which much of income is exempted from taxation or "taxed" at a zero rate and in the rates of tax which apply to the base which remains.

The amount of income excluded from adjusted gross income has been increasing steadily since 1947. The average tax rate on adjusted gross income correspondingly has risen even when the rate on personal income has remained relatively constant. Itemized and standard deductions, along with credits against tax, have also grown at a faster rate than personal income, further reducing the tax base. However, since 1947, these reductions in the base have been more than offset by the decrease, relative to personal income, in the amount of adjusted gross income received by notaxable individuals and,

Figure 5

Cumulative Percent of Personal Income Taxed at or Below each Rate of Tax



most importantly, in the amount of personal exemptions.

Exemptions, standard deductions and the general tax credit determine minimum tax-exempt levels of income. Such levels of income for couples with two children have consistently been quite close to official poverty levels; this relationship has been a deliberate policy at least since 1964. Because incomes have grown faster than official poverty levels (or prices), tax-exempt levels have exempted smaller portions of the population from taxation. Additionally, the decreased importance of the personal exemption *vis-à-vis* the standard deduction, along with increases in the standard deduction, has caused the tax burdens of families with dependents to increase relative to those without dependents.

The rates of tax applying to the tax base have also altered substantially. In the early 1960's, only 10 percent of tax returns faced a positive marginal rate of tax other than 20–22 percent. Since then, the marginal rate of tax has risen for tax returns above the median marginal rate and fallen for taxable returns below the median. In general, over the past two decades the combination of tax increases resulting from higher money incomes and legislated tax reductions has resulted in a more progressive distribution of both personal income and individual tax returns in terms of marginal rate of tax.

FOOTNOTES

**The authors are indebted to Jack Blacksin, Seymour Fiekowsky, Harvey Galper, Michael Kaufman, Ben Okner, Peter Sailor, Emil Sunley, and particularly to the *NTJ* referee for helpful comments, to Stuard Gates for excellent graphics work, and to Adoncia Bratcher for assistance in preparation of the manuscript. Special thanks are due to personnel of the Bureau of Economic Analysis, in particular, Thae Park, who provided much of the data from which Tables A-2 and A-3 were constructed. For a related use of that data, see Park (1981).

[1]Effective tax rates can be measured in several ways. Tax burdens can be based upon receipts or liabilities, while income can be approximated by any one of several measures such as personal income or national income, as defined by the Bureau of Economic Analysis. Figure 1 presents tax burdens on a receipts basis because "liabilities" are not measured for some of the taxes under consideration here. Since later parts of this study use personal income as the measure of the income of individuals, consistency dictated its use in Figure 1 also. Some taxes, such as excise taxes or corporate profits tax, are usually measured as a percent of national income (among several reasons, BEA counts corporate dividends, but not profits, as part of personal income). Nonetheless, the trends presented in Figure 1 would vary little if alternative measures of tax burdens or income were chosen.

[2]Further detail is provided in Table A-1 in the Appendix.

[3]For instance, numbers contained in the Mid-session Review of the Budget for 1981 support this conclusion.

[4]See footnote 1.

[5]For further details, see Appendix Table A-2.

[6]Beginning in 1979 a small portion of total unemployment compensation will be subject to income tax. The exclusion will phase out for a single return with an adjusted gross income, plus unemployment compensation, in excess of $20,000 ($25,000 for joint returns).

[7]For 1981 and 1982 there will be a new exclusion of $200 per taxpayer for interest and dividend income. See the Crude Oil Windfall Profit Tax Act of 1980. This exclusion is likely to be changed in any tax bill passed in 1981.

[8]Of course, the distribution of tax burdens could differ even if the amount of tax collections were the same.

[9]See Steuerle and Hoffman (1979).

[10]Ideally, one would like to separate the AGI of nontaxable individuals from other differences between BEA and IRS measures of AGI. However, while it is possible to identify the adjusted gross income of nontaxable *filers*, the adjusted gross income of nontaxable *nonfilers* is unknown and is treated by BEA as part of a final "unexplained difference" or "reconciliation" between the BEA and IRS measures of AGI. This reconciliation includes nonreported income of taxable filers and nonfilers which should have been reported. When the AGI of nontaxable filers is combined with this reconciliation, as in the second column of Table 2, the AGI of nontaxable *filers* alone comprises at least 30 percent of the total. Like the total, the AGI of nontaxable filers declines relative to personal income; it is reasonable to assume that the AGI of all nontaxable individuals shows a similar trend.

[11]In 1979, the personal exemption was increased from $750 to $1,000, but the value of this increased exemption was largely offset by the elimination of a "general" tax credit available to all taxpayers for the years, 1975–1978.

[12]A high of 10.4 percent was reached in 1970.

[13]See footnote *c* to Table A-5 in the Appendix for further details.

[14]Tax-exempt levels for certain groups of taxpayers may be much higher. For instance, taking into account the tax credit for the elderly, in 1979 the tax exempt level for an elderly couple without social security income ($10,802) was about twice that of a non-elderly couple ($5,400). If the elderly couple had social security income, their tax-exempt level would be even higher.

[15]See Table A-4 in the Appendix for further details.

[16]*General Explanation of the Revenue Act of 1978*, pp. 38–39.

[17]The history of the poverty "line" can be found in Orshansky (1975). Related to its development was the "War on Poverty," officially announced in the Economic Report of the President, January, 1964. Quasi-official poverty levels were designated as an "official" statistical series by the Budget Bureau in 1969.

[18]Similarly, per capita personal income and minimum wages have increased faster than tax-exempt income levels. See Table A-4 in the Appendix.

[19]In the Tax Reform Act of 1969, the Congress also lowered the tax rates of single individuals without lowering the tax rates of married couples. One result of the restructuring of both standard deductions and tax rate schedules has been a "marriage penalty." See Stromquist (1979).

[20]See, for instance, Harberger (1966) or Taubman (1978).

[21]Again, see Appendix for the details of the calculations. Note that marginal tax rates must be measured on a "liabilities" basis. In Figure 1, however, tax rates were measured on a receipts basis. Comparisons between these two figures will still be fairly accurate.

[22]Information on the years 1963 and 1974 are also shown in Table A-5 in the Appendix. In 1963, 1969, and 1974, effective tax rates (Federal income taxes as a percent of personal income) peaked before heading back down again. Measuring "peak to peak" enhances the possibility that detected trends upward or downward do not merely reflect cyclical changes in rates of tax.

[23]Some of the 1969 increase was due to the 10 percent surcharge in effect for that year. See Appendix for details of marginal rate calculations for that year.

[24]Movement into higher brackets through income growth is sometimes called "bracket creep."

[25]The story does not change much if only joint returns are examined. Despite the fact that marginal tax rates for single returns are higher than those for joint returns at a given income level, the distribution of single returns by marginal tax rate resembles closely the distribution of joint returns by marginal tax rate, after account is made for the larger relative number of nontaxable single returns. The median joint return has a marginal tax rate equivalent to the rate applying at about the 60th percentile for all returns. At the 95th percentile, marginal tax rates are close to identical.

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